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THE SOCIAL SECURITY SYSTEM

HEARINGS
BEFORE THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETY-FOURTH CONGRESS
SECOND SESSION

MAY 26 AND 27, 1976

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THE SOCIAL SECURITY SYSTEM

WEDNESDAY, MAY 26, 1976

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:20 a.m., in room 1318, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Sparkman, Proxmire, Javits, and Percy; and Representatives Pike and Heckler.

Also present: William A. Cox, Louis C. Krauthoff, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., and M. Catherine Miller, minority professional staff members.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. Mr. Cardwell, and your associates, thank you very much for your patience. We have a rather rugged day in the Senate today. I was on my way over to see you and all at once the bell rang and we returned to our first line of duty.

This morning, the Joint Economic Committee begins 2 days of hearings on the problems of the social security system. Of course the concern over the social security system is everywhere, and people are asking a number of questions about the solvency of the system and its continuity. We hope to discuss these problems in a clear, objective fashion and begin to determine the best course for Congress to pursue over the coming years. We want to assure the financial soundness of this crucial social insurance program. We know full well that this will not be an easy task. But there are numerous problems facing our social insurance system, and there is disagreement over the seriousness of some of these problems.

There are many proposed solutions. And as you know, they differ radically from each other. And any discussion of social security always arouses strong emotions among the American people. This last element, the emotional involvement of many people, to make social insurance the cornerstone of their retirement plan, cannot and will not be ignored. As we discuss the problems on the different points of view on the social insurance system, I know we will all keep in the back of our minds that the underlying purpose of the entire system is to provide a certain amount of security which people can depend upon in planning for their retirement. Regardless of our political affiliations or our position in and out of Government, we

must remember that their sense of security and dependability must be preserved if our social insurance system is to work properly.

Our first witness this morning is Mr. James B. Cardwell, the Commissioner of the Social Security Administration.

We are very pleased and honored to have you here, Mr. Cardwell. The 1976 annual report of the Board of Trustees of the various insurance systems was issued on Monday. And we look forward to discussing that with you and your associates.

As you know, Mr. Commissioner, we are especially interested in the projections you have made both short term and long term of the surplus or deficit position of the Social Security Trust Fund. Following Commissioner Cardwell's testimony, we will have a panel of three witnesses: Mr. Robert Ball, the former Commissioner of the Social Security Administration, and currently a senior scholar at the Institute of Medicine, National Academy of Sciences; Mr. Nelson Cruikshank, president of the National Council of Senior Citizens; and Miss Harriet Miller, executive director, National Retired Teachers Association and American Association of Retired persons.

Mr. Commissioner, will you please introduce for our record your associates, and then proceed with your prepared statement.

STATEMENT OF HON. JAMES B. CARDWELL, COMMISSIONER, SOCIAL SECURITY ADMINISTRATION, DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE, ACCOMPANIED BY A. HAEWORTH ROBERTSON, CHIEF ACTUARY; JOHN J. CARROLL, ASSISTANT COMMISSIONER, OFFICE OF RESEARCH AND STATISTICS; AND JOHN A. SNEE, DEPUTY DIRECTOR, OFFICE OF PROGRAM EVALUATION AND PLANNING

Mr. CARDWELL. Thank you, Mr. Chairman.

To my immediate right is Mr. Haeworth Robertson, Chief Actuary of the Social Security Administration.

To his right is Mr. Jack Carroll, the Assistant Commissioner for Research and Statistics of the Agency.

To my left is Mr. John Snee, who has been working extensively within the agency on the problem of double indexing that is now in the statute.

Mr. Chairman, I have a prepared statement. In that statement I have attempted to discuss some of the issues that you have outlined, and in addition the problems of termination of coverage of State and local government employees, which is also of interest, as I understand it, to this committee. And the statement also touches on the income redistribution effects of the system.

With your permission, I would like to summarize the statement and give some highlights from it.

Chairman HUMPHREY. Yes; and we will have the entire text, of course, included in the body of our record.

Mr. CARDWELL. I would start out by noting that the timing of this particular hearing is particularly appropriate, in that, as you have said, the Board of Trustees of the system, who operate under law and who are required under law to furnish to the Congress an annual

report, have just furnished their report to the Congress as of last Monday.

As you point out, this program touches just about every American one way or another. And I would like to start out by giving some perspective of the overall scope of the program, then emphasize its features.

Today, more than 32 million people get social security cash benefits totaling about \$6 billion per month. In 1976 about \$76 billion will be paid out in social security cash benefits, and about another \$18 billion in medicare. About 92 percent of all Americans age 65 and older are either getting benefits or would be if their spouses retired—95 out of every 100 children and their mothers can count on a monthly cash benefit if the family breadwinner dies. Four out of five Americans aged 21 to 64 can count on monthly cash benefits in the event of severe, extended disability. About 104 million Americans will work in employment or self-employment covered by social security in 1976—9 out of 10 paid jobs are covered under social security. This gives some idea of why the financial integrity of the social security program is so important.

The financial status of the program can best be discussed, I believe, by separating the discussion into two parts—the short term and the long term, since the problems and issues are different for the two periods.

You mentioned first, Mr. Chairman, that the 1976 trustees' report presents estimates of future operations of the funds based on three alternative sets of economic assumptions. They may be characterized as optimistic, intermediate, and pessimistic. A comparison of the three sets of assumptions is included at the end of the statement, and is available to the committee. We would like to center our discussion on the status of the trust funds under the intermediate set of assumptions.

The trustees' report shows that the social security cash benefits trust funds will decline from their present level of \$44.3 billion until they are exhausted in the 1980's. The annual deficit for the combined trust funds is expected to rise from \$4.3 billion this year to over \$8.5 billion by 1981.

In the following year the combined funds would be depleted. The trustees' projections show that the disability fund itself, as a part of the combined, will be depleted by 1979.

As the members of this committee recognize there is a wide variety of assumptions that could be used for projecting income and outgo of the social security program. At the time the administration presented its 1977 budget, the estimates contained therein of the short-range financial status of the trust funds were different from those prepared at about the same time by the Congressional Budget Office. Since that time, we have revised our estimates—as reflected in the 1976 trustees' report. We understand that the CBO has also revised its estimates. Although there are slight differences between the trustees' intermediate assumptions and what we understand to be the CBO's latest assumptions, the point to be made—and I would like to emphasize it—is that when arrayed alongside each other, these two estimates produce essentially the same end result as of 1981. They reach essentially the

same conclusion, that unless additional revenue is developed, or unless the benefit structure were to be revised, the funds would be depleted by about that time.

I would also add that even if one were to assume that the economy would recover at a somewhat faster pace than under the intermediate or the CBO assumptions, the funds would still decline. For example, projections based on the trustees' optimistic set of assumptions show that, at best, the funds would not last beyond the mid-1980's.

Why do we have the short-range deficit? Why have the trustees and the Congressional Budget Office, for example, project such deficits?

Simply and directly stated, these projections reflect developments in the national economy. As the committee knows, in the last few years we have had an unusual situation, wherein both high unemployment and high inflation have obtained. High unemployment of course means fewer workers paying into the system, and under an indexed system inflation means higher benefits being paid out.

Also, the disability insurance rolls, which now constitute a very important segment of the total program, have been growing more rapidly than was anticipated even a few years ago.

Thus the major conditions that are producing the current deficit are a higher outgo and a lower income than were previously anticipated.

Although the economy is on a path of recovery, we cannot prudently expect the recovery to overcome the impact of the recent high inflation on the social security benefit outgo for at least the next several years. In any case it seems likely that the Nation will experience relatively high rates of inflation and high rates of unemployment this year and for the next several years, and we must be prepared to deal with this possibility, and perhaps probability.

The real question for the near term as we see it is: "What is the critical point below which the trust fund levels should not be allowed to fall"? This is a matter of judgment. In our opinion the trust funds should not be allowed to fall below a level of about one-third of a year's expenditures. While we recognize that reasonable people may differ as to how low the trust fund can fall without endangering the integrity of the system, we are concerned about the erosion of public confidence, the point that you emphasized, Mr. Chairman, which occurs as funds decline to lower and lower levels.

Also we believe some cushion should be retained to carry the funds through periods where a rate increase might be desirable, but must be postponed because of economic conditions as of that moment. Such a reserve is also necessary to allow time for public policymakers to take action to preserve the integrity of the system.

In view of these concerns we believe that the combined cash benefits trust funds should not be allowed to fall below the level of the one-third that we mentioned awhile ago.

With this in mind the administration has proposed that the current cash benefits tax rate be increased, effective in 1977, by three-tenths of 1 percent each for employees and employers, and by nine-tenths of 1 percent for the self-employed. When combined with the earnings base increases that will automatically occur under the present law, these rate increases should be sufficient to maintain the trust funds at a level of about one-third of the following year's outgo until 1982.

Now, I would like to take up the subject of the long-term status.

As I am sure the committee recognizes, the actual future income and expenditures of the system will depend upon a large number of factors: The type and level of benefits payable, the size and characteristics and composition of the population eligible for benefits, and the population paying social security taxes to support these benefits. These characteristics and conditions in turn depend upon such things as future fertility rates, mortality rates, migration rates, labor force participation and unemployment rates, disability rates, retirement age patterns, and divorce and remarriage rates—they all enter into the picture. Also wage patterns and changes in the Consumer Price Index are certainly an important and key element.

As I mentioned earlier, the trustees, in recognition of the difficulty of making cost estimates with any degree of certainty, elected to present in this year's trustees' report projections based upon three alternative sets of demographic and economic assumptions. These three sets of assumptions demonstrate that the projected status of the trust funds can vary widely depending on one's view of future economic and demographic developments.

Under the so-called intermediate estimates it is assumed that over the long range the average annual rates of increase in wages and prices—the cost-of-living index—will be 5.75 percent and 4 percent respectively. Thus the average annual increase in real wages, or in productivity, would be about 1.75 percent. And a 5-percent unemployment rate is assumed, under the same set of intermediate projections. For the more optimistic estimates lower wage and price increases and lower unemployment levels are assumed, as is higher real wage growth, 2.25 percent per year.

With regard to demographic factors, to be optimistic we show an ultimate fertility rate of about 2.3 percent, whereas the pessimistic view would show an assumption of 1.7 percent; 1.9 percent has been used in the intermediate set of assumptions.

Under the intermediate set of assumptions the 1976 trustee's report shows a long-range deficit for the cash benefits program under present law averaging 7.96 percent of taxable payroll, the payroll base to which the tax rate would be applied, over a 75-year period. This long-term deficit is primarily a result of three factors. The way in which future benefits are related to both inflation and real wage growth is one factor.

And the 1.9 fertility rate is very important. This is below the population replacement level.

Finally, the projected higher disability incidence rate has a significant impact on long-term costs.

The first of these three important elements of consideration involves the so-called coupled benefit structure that now exists in law. Under the present structure potential future benefit levels for current workers and their families are high highly sensitive to increases in wages and prices, and the relationship between them. Under present law everytime a cost-of-living benefit increase is computed for retirees, the same factor is also used to increase future benefit levels for current workers. This produced the so-called double index. This is a flaw in the automatic adjustment provisions that tends to overcompensate for inflation.

Chairman HUMPHREY. I am sure you have brought that to the attention of the Finance Committee?

Mr. CARDWELL. The President has indicated to the Congress that he will propose a specific plan. We have worked out a plan. The Finance Committee and Ways and Means Committee have also been analyzing alternative plans themselves. And we would expect to present to the Congress a detailed proposal in the form of legislative probably next month.

Perhaps the best way to illustrate this flaw is to look at what happens to replacement rates, that share of a worker's preretirement earnings replaced by the social security retirement benefit. Under the intermediate economic assumptions the present formula will result in an unintended steady rise in replacement rates for all workers. For some workers, those at the lower end of the wage scale, the replacement rate is now about 62 percent—in other words, when the average person retires in a lower income scale today, he can expect to receive a continuing retirement benefit equal to about 62 percent of his wages. Over the long term this would increase to over 100 percent. In other words, the present formula will result in a significant number of workers receiving social security benefits that exceed their preretirement earnings.

The President, as I just mentioned, has proposed that this flaw be corrected by separating these two computations. This separation is called by the people that work on the subject decoupling. And I am sure you will hear a great deal more about it.

I would like to make one last point about decoupling. It becomes a very important consideration as one looks to the long term. This is something we try to stress and talk to people about concerning the long-term financing dilemma. It is probably highly unreasonable to expect a 7.96-percent deficit to obtain, because we can't really assume that the public policymakers, the Congress and the executive, would allow this unintended effect to prevail. And as the trustees' report says, under the intermediate set of assumptions, if we do correct the flaw we cut that amount almost in half, and would end up with a deficit after the adjustment is made of about 4.3 percent.

Now, this remaining deficit, 4.3 percent, that would occur after so-called decoupling, is due largely to the recent sharp decline in birth rates, with the assumption that these relatively low birth rates, less than replacement levels, will continue on into the future. If current population trends continue and our projections about the future composition of the labor force hold, future years will witness a relatively smaller work force, that is, a work force expanding at a slower rate than the beneficiary population, and consequently a decrease in the number of social security contributors relative to the number of persons eligible for benefits. It is anticipated that the current ratio of 30 beneficiaries to every 100 workers will, by the year 2030, increase to 50 or more beneficiaries per 100 workers. Thus relatively fewer workers will be supporting more beneficiaries.

I would now like to skip a page, if you will, and talk very briefly about State and local coverage. I would, for the purpose of introducing the subject, just mention that this is a matter of growing concern on the part of the public. And it also is a matter of concern on the part of us who have stewardship responsibilities for the pro-

gram. The Ways and Means Committee of the House is reviewing the subject.

I think the present round of publicity may well overstate the matter. But it is a matter that deserves attention and concern by both the Executive and the Congress.

If you would, Mr. Chairman, I would next turn to the relationship of social security to other Government programs, something that I understood the committee wanted to cover.

As is well known, social security is the largest social insurance program that we have, and represents the primary reliance of retired workers and disabled workers and their dependents, and the survivors of deceased workers. There are of course other social insurance programs—unemployment insurance, workman's compensation, and in a few States temporary disability insurance. These forms of insurance cover risks not covered by social security.

In addition, the Nation has a variety of needs-tested programs for persons not covered by social insurance, or for whom social insurance benefits, plus private resources, prove to be insufficient to meet individual family needs. Such needs-tested programs include the Federal SSI system, the State supplementary payments to that program, the Federal-State AFDC program, and other programs such as medicaid and food stamps.

The social insurance programs are generally financed by payroll contributions—or dedicated taxes, if you will—with or without explicit employee contribution, and payable as an earned right.

The needs-tested programs, in contrast, are generally financed from the general funds of the Treasury, which of course represent a more progressive tax base. These programs provide benefits only to those whose income and resources are too low to meet a defined standard of need.

On this basis, then, the social insurance programs are designed to prevent economic insecurity and financial need, and the needs-tested programs are available as a backstop to the alleviation of poverty and want after it has arisen and to meet the needs not met by social insurance.

Now, on the matter of the redistributive effects of social security: As you know, Mr. Chairman, the social security program does have certain income redistribution aspects that have a bearing on other Federal income maintenance programs, and of course have a bearing on the cost of social security. The other programs affected are the supplemental security income and the other needs-tested services and benefit programs that we mentioned, which are ones financed by general revenues.

Social security redistribution occurs in several important ways. First, since today's social security benefits are paid by current workers' social security taxes, social security redistributes income from today's workers to today's retired and disabled beneficiaries and their dependents, and their survivors. Second, the weighting in the social security benefit formula, which provides for a larger percentage replacement of preretirement earnings for lower-paid earners than for higher-paid earners, social security redistributes income from the haves to the have-nots. This recognizes the fact that lower-paid earners

have less margin for reduction in their income than do, of course, higher-paid earners.

Another way social security redistributes income is from a single worker to a married worker, paralleling many taxes. Since social security benefits are payable to a worker's dependents and survivors, a married worker who has a spouse and children is likely to receive more benefits in relation to his contributions than would a single person.

Mr. Chairman, there are some people who argue that the social or the so-called welfare aspects of social security should be met through a needs-tested program such as SSI and should be financed out of general revenues rather than through dedicated taxes. They argue that since we now have Federal SSI, these social aspects are inconsistent with the insurance nature of the system. This is an argument that has been going on in one form or another for many years, before SSI, for that matter. Obviously this is an area that raises a number of complex questions which in turn involve a range of value judgments. The one point we would make here is that the basic concepts that underlie the relationship between social insurance and needs-tested programs have not been essentially changed because of the enactment of SSI.

We would, of course, be glad to discuss this subject with you if you prefer.

This concludes my prepared statement. And we would, of course, like to try to answer any questions that you might have.

[The prepared statement of Mr. Cardwell follows:]

PREPARED STATEMENT OF HON. JAMES B. CARDWELL

Mr. Chairman, I am pleased to have the opportunity to discuss with you today the financial status of the social security cash benefits program. I am accompanied by A. Haeworth Robertson, Chief Actuary; John J. Carroll, Assistant Commissioner, Office of Research and Statistics; and John Snee, Deputy Director, Office of Program Evaluation and Planning.

Mr. Chairman, I will be discussing the financial status of the old-age and survivors insurance and the disability insurance trust funds and the principal assumptions on which the estimates of trust fund operations are based, as contained in the latest annual report of the Board of Trustees, which was released on Monday. As you requested, Mr. Chairman, I will also be discussing the problem of termination of coverage of State and local government employees and some of the income redistribution effects of social security and its relationship to SSI.

Before discussing these issues, I would like to give some perspective of the overall scope of the social security program. Today, more than 32 million people get social security cash benefits totaling about \$6 billion per month. In 1976, about \$76 billion will be paid out in social security cash benefits, and about another \$18 billion in Medicare. About 92 percent of all Americans age 65 and older are either getting benefits or would be if their spouses retired. Ninety-five out of every 100 children and their mothers can count on monthly cash benefits if the family breadwinner dies. Four out of five Americans aged 21-64 can count on monthly cash benefits in the event of severe, extended disability. About 104 million Americans will work in employment or self-employment covered by social security in 1976. Nine out of ten paid jobs are covered under social security. This gives some idea of why the financial integrity of the social security program is so important.

The financial status of the program can best be discussed, I believe, by separating the discussion into two parts—the short term and the long term. I believe such an approach will facilitate understanding of the problems and issues involved.

SHORT-TERM STATUS

I might mention first, Mr. Chairman, that the 1976 trustees' report presents estimates of the future operations of the trust funds based on three alternative

sets of economic assumptions which may be characterized as optimistic, intermediate, and pessimistic sets of assumptions. A comparison of the three sets of assumptions is included at the end of my statement. My discussion of the status of the trust funds is based on the intermediate set of assumptions.

The trustees' report shows that the social security trust funds will decline from their present level of \$44.3 billion until they are exhausted in the 1980's. The annual deficit for the combined trust funds is expected to rise from \$4.3 billion this year to over \$8½ billion in 1981. In the following year, the combined funds would be depleted. The trustees' projection show that the disability fund will be depleted in 1979.

As the members of this committee recognize there is a wide variety of assumptions that could be used for projecting income and outgo of the social security program. At the time the Administration presented its 1977 budget, the estimates contained therein of the short-range financial status of the trust funds were different from those prepared at about the same time by the Congressional Budget Office. Since that time, we have revised our estimates—as reflected in the 1976 trustees' report. We understand that the CBO has also revised its estimates. Although there are slight differences between the trustees' intermediate assumptions and what we understand to be the CBO's latest assumptions, the balance of the combined cash benefits trust funds at the end of fiscal year 1981 will probably be about the same under both sets of the assumptions. Under the intermediate assumptions the figure is about \$15.9 billion.

I would also add that even if one were to assume that the economy would recover at a somewhat faster pace than under the intermediate or the CBO assumptions, the funds would still decline. For example, projections based on the trustees' optimistic set of assumptions show that, at best, the funds would not last beyond the mid-1980's.

REASONS FOR SHORT-RANGE DEFICITS

Why are the trustees projecting annual deficits in the trust funds? Simply and directly stated, to reflect developments in the national economy. As everyone on this committee knows, during the last few years we have been in the unusual situation of having both high unemployment and high inflation. High unemployment means fewer workers paying into the system, and inflation means higher benefits going out—since social security benefits are automatically increased as the Consumer Price Index rises. Also, the disability insurance rolls have been growing more rapidly than was anticipated a few years ago. Thus, the major conditions that are producing the current deficits are higher outgo and lower income than were anticipated a few years ago.

Although we are on a path of economic recovery, we cannot prudently expect the recovery to overcome the impact of the recent high inflation on the social security benefit outgo over the next few years: In any case, it seems likely that the Nation will experience relatively higher rates of inflation and high unemployment this year and for the next several years, and we must be prepared to deal with this possibility.

ADMINISTRATION PROPOSAL

The real question for the near term is: "What is the critical point below which trust fund levels should not fall?" In our opinion the trust funds should not be allowed to fall below a level of about one-third of a year's expenditures. While we recognize that reasonable people may differ as to how low the trust funds can fall without endangering the integrity of the system, we are concerned about the erosion of public confidence that occurs as the funds decline to lower and lower levels. Also, some cushion should always be retained to carry the funds through periods where a rate increase is desirable, but must be postponed because of economic conditions. Such a reserve is also necessary to allow time for public policymakers to take action to preserve the integrity of the system. In view of these concerns, we believe that the combined cash-benefits trust funds should not be allowed to fall below a level of about one-third of a year's expenditures.

With this in mind, the Administration has proposed that the current cash benefits tax rate be increased effective in 1977, by three-tenths of 1 percent each for employees and employers, and by nine-tenths of 1 percent for the self-employed. When combined with the earnings base increases that will automatically occur under present law, the rate increases should be sufficient to maintain the trust funds at a level above one-third of the following year's outgo until 1982.

I can assure you, Mr. Chairman, that the President gave very careful consideration to all of the revenue options before reaching his decision. Other options were to increase the earnings base or to have a rate increase and a base increase in excess of the automatic base increase that will occur under present law. In considering this option, it was recognized that the base has increased rapidly in recent years and under present law is expected to increase \$1,200 to \$16,500 in 1977. In effect, the President's proposal takes these increases into account. The additional revenue expected to be produced in 1977 would come from the proposed rate increase, together with the increase in the base that will automatically occur under the law and the normal year-to-year rise in average earnings covered under the system.

For example, under the automatic base increase in 1977, a worker earning \$16,500 or more would pay an additional \$70 a year in social security taxes. The proposed rate change would add another \$49, for a total increase of \$119 for the year. On the other hand, a worker earning \$7,500 in 1977 would pay only an additional \$22 in social security taxes under the proposal.

A second consideration is that any rise in the wage base now increases future benefit rights, which adds to outgo over the long term. We do not believe it wise to further increase long-term expenditures.

In summary, the proposed rate increase would build upon a wage base increase already in place. In addition, a rate increase means that the cost of providing the additional funds would be shared by all workers and will minimize the impact of the increase on any one worker or particular group of workers.

Another option often advanced is to inject general revenue funds into the social security program. The Administration believes that in time this would erode the earned-right principle that is fundamental to social security. We also believe that it would lead to pressure to further expand the program and thus increase future cost commitments. Unless other expenditures are decreased, use of general revenues would mean either increased Federal borrowing and an increase in the Federal deficit or an increase in general tax revenues.

LONG-TERM STATUS

Now, Mr. Chairman, let me turn to the long-term financial status of the program. As I am sure you recognize, Mr. Chairman, actual future income and expenditures will depend upon a large number of factors: the type and level of benefits payable; the size, characteristics, and composition of the population receiving benefits and the population paying social security taxes. These in turn depend upon such things as future fertility rates, mortality rates, migration rates, labor force participation and unemployment rates, disability rates, retirement age patterns, divorce and remarriage rates, etc. Also, of course, wage patterns and changes in the Consumer Price Index are key elements.

It is obviously impossible to know with any degree of certainty what the future holds with respect to these demographic and economic factors. The best that can be done is to make long-range estimates based upon assumptions as to the future behavior of these demographic and economic factors, which will indicate the trend and general range of future income and outgo. Even with their limitation, such estimates, and their underlying assumptions, if revised periodically in the light of developing trends, provide information which is useful for making necessary policy decisions.

As I mentioned earlier, the trustees, in recognition of the difficulty in making cost estimates with any degree of certainty, elected to present in this year's trustees' report projections based upon three alternative sets of demographic and economic assumptions. These three sets of assumptions demonstrate that the projected status of the trust funds can vary widely depending on actual future economic and demographic experience.

Under the so-called intermediate estimates it is assumed that, over the long range, the average annual rates of increase in wages and prices (CPI) will be 5½ percent and 4 percent, respectively. Thus, an average annual increase in real wages of 1¼ percent is assumed. And a 5 percent unemployment rate is assumed. For the more optimistic estimates, lower wage and price increases and lower unemployment are assumed, as is higher real wage growth—2¼ percent per year. With regard to demographic factors, the ultimate fertility rate used varies from 2.3 under the more optimistic assumptions to 1.7 under the pessimistic ones, with 1.9 being used in the intermediate set of assumptions.

Under the intermediate set of assumptions, the 1976 trustees' report shows a long-range deficit for the cash benefits program under present law averaging 7.96

percent of taxable payroll over the 75-year valuation period. This long-term deficit is primarily a result of three factors:

- The way future benefits are related to both inflation and wage growth.
- The 1.9 fertility rate, which is below the population replacement level.
- The projected higher disability incidence rates.

COUPLED BENEFIT STRUCTURE

Under the present benefit structure, potential future benefit levels—for current workers and their families—are highly sensitive to increases in wages and prices and the relationship between them. Under present law, every time a cost-of-living benefit increase is computed for retirees, that same factor is also used to increase future benefit levels for current workers. This is a flaw in the automatic adjustment provisions that tends to overcompensate for inflation.

Perhaps the best way to illustrate this flaw is to look at what happens to replacement rates—that share of a worker's preretirement earnings replaced by his social security benefit.

Under the intermediate economic assumptions, the present formula will result in an unintended steady rise in replacement rates for all workers. For some workers—those at the lower end of the wage scale—the replacement rates will rise from the present 62 percent level to over 100 percent. In other words, the present formula will result in a significant number of workers getting social security benefits that exceed their preretirement wages.

The President has proposed that this flaw be corrected by separating these two computations. This separation is what we term "decoupling." Under the proposal, the computation of benefit increases for current beneficiaries based on increases in prices would be entirely separate from the computation of initial benefit amounts for new beneficiaries which would be based on wages. (For purposes of initial benefits, the wages would be updated in relation to increases in average wages, but there would be no separate adjustment for changes in the CPI, as there is under present law.)

The purpose of our decoupling proposal is to cause future benefit levels to be less sensitive to fluctuations in wage and price increases and also to assure that replacement rates will be relatively constant over time. Our objective is to stabilize replacement rates—not social security benefit amounts. Under the proposal, future replacement rates will remain at approximately current levels and initial benefit amounts will generally rise over time as wages rise.

I would emphasize that this change would not affect existing automatic cost-of-living increases for people after they become beneficiaries. Under our proposal, as under present law, benefits will be adjusted automatically for changes in the cost of living as measured by the Consumer Price Index so that the beneficiary's purchasing power will be maintained as long as he or she is on the beneficiary rolls. The decoupling proposal does not attempt to overhaul or reform the total system. Existing features of the law that serve as the basis for determining benefit rights will remain in large part unchanged.

Mr. Chairman, the decoupling plan that we will submit shortly to the Congress is designed solely for the purpose of correcting the replacement rate aberration. In doing so it will eliminate about one-half of the projected long-term deficit. To this extent, that 7.96 long-term actuarial deficit is misleading. We believe Congress will not permit this unintended double indexing to continue. Thus, the long-term deficit should more properly be considered to be about 4.3 percent.

Furthermore, decoupling will not (and is not intended to) have a remedial effect on the short-term deficits. Its adoption would, though, reduce significantly the projected long-term costs of the system. The Administration believes that an early decision about decoupling is the necessary first step in solving the long-range deficit.

DEMOGRAPHIC FACTORS

The remaining deficit—about 4.3 percent after decoupling—is due largely to the recent sharp decline in birth rates and the assumption that these relatively low birth rates—less than replacement levels—will continue into the future. If current population trends continue and our projections about the future composition of the labor force hold true, future years will witness a relatively smaller work force—that is, a work expanding at a slower rate than the beneficiary population—and, consequently, a decrease in the number of social security contributors relative to beneficiaries. It is anticipated that the current ratio of 30 beneficiaries for every 100 workers will, by the year 2030, increase.

to 50 or more beneficiaries per 100 workers. Thus, relatively fewer workers will be supporting more beneficiaries.

In reviewing long-range estimates based upon demographic conditions postulated to exist some 75 years from now, it would be well to keep in mind the following: Although the underlying assumptions for these long-range estimates may appear to be reasonable, based upon current understanding, in some cases the assumptions produce results so different from the current situation that attention should be directed toward the overall implications of these assumptions and not just toward their effect on the single issue of financing the social security cash benefits program.

We believe it is important to recognize that if the population composition should change in accordance with these assumptions, there are likely to be substantial changes in many of the nation's social and economic arrangements. Some things to be considered are:

If health and life expectancy improve, and if demand for labor increases, it is possible that workers will retire at later ages (contrary to present trends), which would result in a substantial improvement in the financial situation of the social security program.

If future birth rates remain low, child-related dependency costs to society will be relatively lower—less money will be required for items such as child care and education—and it may be feasible to devote larger amounts of money to retirement needs.

If the future birth rates are low and the economy continues to grow, there is a possibility that more immigrants will be permitted to enter the country, which would offset, at least partially, the effect of low birth rates.

OTHER LONG-TERM CONSIDERATIONS

Although long-term estimates associated with the social security program are subject to substantial changes because of the uncertainty inherent in an attempt to forecast future economic and population changes, nevertheless, we believe that they are valuable for planning purposes. Since decoupling will solve only one-half of the long-term deficit under the intermediate assumptions, we intend to undertake a thorough review of all aspects of the basic principles and concepts underlying the social security programs.

This review will include a canvassing of the benefit formula and structure, financing alternatives, and analysis of how disability concepts might be better integrated into an income replacement program, a fresh look at coverage provisions, and a reappraisal of the proper relationship of social security and other income replacement programs.

Although such a review should be undertaken expeditiously, there is no need for hasty action once the short-term problem is addressed through the proposed tax increases and decoupling is adopted.

STATE AND LOCAL COVERAGE TERMINATIONS

Let me now turn to another issue that has been in the news lately and in which the committee has expressed an interest.

During the past few months, considerable attention has been focused on the withdrawal of State and local government employees from social security coverage, especially on the notice given by the State of New York of its intent to terminate the social security coverage of almost all of the employees of the City of New York.

This situation brings to public attention the fact that not all workers in the United States are covered under the social security program, and that some workers are covered on an elective basis and have the option of withdrawing their participation in the program—while the vast majority of those covered do not have the same option.

Unlike coverage for the work force as a whole, social security coverage for employees of the States and their political subdivisions is exercised at the option of the State or local jurisdiction on a voluntary, group basis. This is executed through agreements between the State and the Secretary of Health, Education, and Welfare.

About 70 percent of the 12 million State and local employees are covered under social security under these agreements. Most of the remaining 30 percent could be covered under social security but the States have not exercised their option.

Some idea of the extent of the current termination activity may be helpful in placing the problem in perspective. Through March 1972, coverage had been terminated for 133 entities employing less than 10,000 workers. In the following

4 years—by March 1976—the number of entities terminated had increased by 21½ times, and the number of terminated employees increased by more than 4 times. In the next 2 years, based on current requests, coverage could be terminated for an additional 232 entities employing about 454,000 workers. Of course, the termination notice affecting by far the largest number of employees is the notice of termination for most of the employees—about 362,000—of New York City.

We are very much concerned about the adverse effects that these terminations have on the benefit protection of workers whose coverage is terminated and on the financial and programmatic integrity of the social security trust funds.

Some of these terminated workers may find themselves ineligible for social security benefits and without adequate protection under other plans. This is especially true with respect to the younger members of the group who have a greater need for the survivors and disability protection provided under social security. All members of the group will, of course, lose their social security disability protection after 5 years. Others may find themselves with little or no group-type protection in place of social security.

For those who remain eligible for social security, the problem becomes one of paying "windfall" benefits to them, the cost of which must be borne by all other social security taxpayers.

Termination of coverage for a large number of employees would have an adverse short-range effect on the trust funds. For example, if coverage is terminated effective March 1978 for workers who are subject to the termination notice filed by New York City, the social security trust funds would lose, in net income terms, an estimated \$3.1 billion in contributions and interest during the 5-year period 1978-1982.

The long-range costs would be increased only slightly—about 0.02 percent of taxable payroll for the cash benefits program and 0.01 percent for the hospital insurance program.

While these costs in themselves are not large, the cumulative effect of a large number of major city or State withdrawals from social security coverage could be substantial. If, for example, 50 percent of all State and local employees had their coverage terminated as of June 1978, the total loss in contribution and interest income for the 5-year period would be \$37.2 billion and, of course, the long-range deficit would be further increased.

As I testified before the Subcommittee on Social Security on April 26, there are a number of possible approaches to this termination problem, all of which are complicated and have far-reaching implications. I would be glad, Mr. Chairman, to supply a copy of my April 26 testimony for the record.

RELATIONSHIP OF SOCIAL SECURITY TO OTHER GOVERNMENT PROGRAMS

Mr. Chairman, you also asked me to discuss the relationship of the social security system to other income maintenance programs and some of the redistributive effects of social security, which are, of course, different from redistributive aspects of other Federal income maintenance programs.

As you know, social security is our largest social insurance program and the primary reliance of retired and disabled workers and their dependents and the survivors of deceased workers. There are other social insurance programs—unemployment insurance, workmen's compensation, and (in a few States) temporary disability insurance, which cover risks not covered by social security.

In addition, the Nation has a variety of needs-tested programs for people not covered by social insurance or for whom social insurance benefits plus private resources are insufficient to meet individual or family needs. Such needs-tested programs include the Federal SSI system, State supplementary payments, the Federal-State AFDC program, and also programs such as medicaid, food stamps, et cetera.

The social insurance programs are generally financed by payroll contributions (with or without an explicit employee contribution) and payable as an earned right. The needs-tested programs are generally financed from general revenues—which has a more progressive tax base—and provide benefits only to those whose income and resources are too low to meet a defined standard of need. On this basis, then, the social insurance programs are designed to prevent economic insecurity and financial need and the needs-tested programs are available as a backstop to alleviate poverty and want after it has arisen and to meet needs not met by social insurance.

Let me turn now to the redistributive effects of social security. As you know, Mr. Chairman, the social security program does have certain income redistribu-

tion aspects that have a bearing on other Federal income maintenance programs, such as the supplemental security income program and other needs-tested programs which are, of course, financed from general revenues.

Social security redistributes income in several major ways. First, since today's social security benefits are paid from today's social security taxes, social security redistributes income from today's workers to today's retired and disabled beneficiaries and their dependents, and survivors of deceased workers.

Second, by the weighting in the social security benefit formula, which provides for a larger percentage replacement of preretirement earnings for lower-paid earners than for higher-paid earners, social security redistributes income from higher-paid earners to lower-paid ones. This recognizes the fact that lower-paid earners have less margin for reduction in their income than do higher-paid earners.

Another way social security redistributes income is from single workers to married workers. Since social security benefits are payable to a worker's dependents and survivors, a married worker who has a spouse and children may receive more benefits in relation to contributions paid than does a single worker.

As you know, Mr. Chairman there are some people who argue that the social or welfare aspects of social security should be met through a needs-tested program such as SSI and financed out of general revenues rather than through dedicated payroll taxes. They argue that since we now have a Federal SSI program, these social aspects are inconsistent with the insurance nature of the social security system.

Obviously, this is an area that raises a number of complex questions which, in turn, involve a range of value judgments. The one point we would make here is that the basic concepts that underlie the relationships between social insurance systems and need-tested programs have not been essentially changed because of the enactment of the SSI program.

CONCLUSION

That concludes my prepared statement, Mr. Chairman. I will be happy to answer any questions the Committee may have.

ASSUMED PERCENTAGE INCREASE OVER PRIOR YEAR IN ANNUAL AVERAGE REAL GNP, IN ANNUAL AVERAGE WAGES, AND IN ANNUAL AVERAGE CPI, AND ASSUMED AVERAGE ANNUAL UNEMPLOYMENT RATE, UNDER 3 ALTERNATIVE SETS OF ASSUMPTIONS, CALENDAR YEARS 1975-81

Calendar year	Percentage increase in annual average—			Average annual unemployment rate (percent)
	Real GNP ¹	Wages	CPI	
Alternative I:				
1975.....	-2.0	6.8	9.1	8.5
1976.....	6.2	7.7	6.3	7.7
1977.....	5.7	8.5	6.0	6.9
1978.....	6.5	9.6	5.5	6.3
1979.....	6.5	9.1	5.0	5.6
1980.....	6.5	8.1	4.0	5.0
1981.....	5.5	6.8	4.0	4.5
Alternative II:				
1975.....	-2.0	6.8	9.1	8.5
1976.....	6.2	7.7	6.3	7.7
1977.....	5.7	8.5	6.0	6.9
1978.....	5.5	9.4	6.0	6.6
1979.....	5.5	8.5	5.5	6.2
1980.....	5.5	7.7	5.0	5.7
1981.....	5.5	6.7	4.5	5.2
Alternative III:				
1975.....	-2.0	6.8	9.1	8.5
1976.....	6.2	7.7	6.3	7.7
1977.....	4.0	8.0	6.0	7.6
1978.....	4.0	8.9	6.5	7.6
1979.....	4.0	7.9	6.0	7.6
1980.....	4.0	7.4	5.5	7.5
1981.....	4.0	6.6	5.0	7.4

¹ Based on GNP expressed in 1972 dollars (i.e., total output of goods and services adjusted for inflation since 1972).

Chairman HUMPHREY. Mr. Cardwell, we thank you. And your testimony is helpful and constructive. I think your testimony itself reveals the complexity of the program. And also of course it is of im-

mense value to the individuals, the recipients. The figures show that the benefits which you have presented on a monthly basis came to \$6 billion per month in 1976; \$76 billion will be paid off in social security cash benefits, and another \$18 billion in medicare I think indicates the impact of the program economically on the American economy. It tells us a great deal about the redistribution of income due to the social security system.

I am not being critical at all. As a matter of fact, I would say that this is one of the heartening developments that people who have received these benefits have been able to be active in the marketplace where they purchase their goods and services, at least in part what they need.

I have a couple of questions that I want to ask you, because the projections that you make on the basis of optimistic, intermediate, and pessimistic, I think, necessitates some further discussion.

Using your intermediate alternative, you project that expenditures as a percentage of taxable payroll will be about 19 percent, is that correct?

Mr. CARDWELL. That is correct.

Chairman HUMPHREY. When compared to the tax rate currently under the law, about 11 percent, this implies that the long-range deficit is roughly 8 percent. I understand about one-half of this deficit can be eliminated by what you describe as decoupling, that is, by eliminating the excessive inflation adjustment for current workers as implied by existing law. Are these estimates that I have given approximately correct?

Mr. CARDWELL. Yes, sir.

Chairman HUMPHREY. Since there seems to be no disagreement that decoupling should and will occur if it becomes a serious threat, maybe I am being too optimistic there, but I believe not, the deficit remaining—and I believe you indicated this in your testimony—is roughly 4 percent of taxable payroll?

Mr. CARDWELL. Right, sir.

Chairman HUMPHREY. Now, the President, and consequently the social security trustees, have proposed a tax rate increase of six-tenths of 1 percent for employers and employees, and nine-tenths of 1 percent for self-employed persons. How much of the four percent deficit which remains after decoupling would be eliminated by the President's proposal?

Mr. CARDWELL. Essentially none, sir. The President's proposal would have, insofar as tax rate changes are concerned, mainly a short-term effect. The 4-percent deficit that we have just identified, post-decoupling, for the long term would not be affected much.

Chairman HUMPHREY. So you would still have the 4-percent deficit hanging over the system?

Mr. CARDWELL. Well, the Actuary says the rate increase would have some long-term effect, but it would not significantly change the long-term deficit.

Chairman HUMPHREY. So it is your testimony that the deficit position would still continue?

Mr. CARDWELL. Yes, sir.

Chairman HUMPHREY. Even with the so-called increased tax proposal?

Mr. CARDWELL. Yes; that proposal is really designed to close the gap between income and outgo as soon as possible, in order to insure that the reserve levels remain at at least a minimum level. It is designed largely, as I pointed out in the statement, for two purposes, to attempt to restore public confidence in the integrity of the system for the short term, and to provide ourselves with the necessary reserves and protective devices that we would need should something unanticipated occur during the short term.

I have asked Mr. Haeworth Robertson, the Actuary, to comment on the precise effect of the rate increase on the long-term deficit if you would like.

Chairman HUMPHREY. Yes; but just let me give you another point that might fit in here.

Our staff has looked over the trustee's report, and that report states that the projections are very sensitive to economic assumptions, which is understandable. But I want to understand just how critical these assumptions really are. For example, looking at appendix table E, page 141 of your trustees' report, it shows that by changing the fertility assumption from 1.9 to 2.3, and holding everything else constant, almost 1½ percent of the long-range deficit disappears. And then appendix table G, page 147 of the trustee's report, shows that by assuming real wages increased to 2½ percent rather than the intermediate at 1¾ percent, about 3½ percent of the long-range deficit disappears. Thus small adjustments of these critical assumptions can have major impacts on your forecast. Once the decoupling has been taken care of, a judicial choice of these assumptions can lead to almost any conclusion you wish, in fact absent decoupling problems, one could choose reasonable assumptions which would lead to the conclusion that there is no long-range deficit. Do you agree, is that an assumption that we should make? And your actuary may want to get into this.

Mr. CARDWELL. I would like to have him speak to this. He has worked long and hard on that question.

I think it is fair to say that there is a range of reasonableness as to what to expect from the long term. I would agree with you that the opportunity for choices within that range are fairly significant. But the range that the trustees identify represent, in my judgment, the extremes that are likely to occur. Other things could occur, of course.

It would be a mistake to assume there would be no deficit if we decouple. Decoupling will make the system less sensitive, less vulnerable, in the long term, to shifts in wages and prices. The system, though, would continue to be very sensitive to our projections of the population. And of course we are in a field here that obviously is changing, and a field in which very few of us have any license for special projections. It would appear that we are headed in the direction of a long-term trend of lower population growth. But there are a lot of uncertainties. What we are doing here is reflecting a kind of consensus—a kind of consensus is emerging among the monitors. How long this consensus will prevail I cannot say.

I would like to cite for you what I think the elements of consideration are. The assumption that we as a population will lower the rate at which we are having children rests first of all, on the assumption that we have and will continue to have reliable birth control devices.

Not everybody, of course, would agree that they are that reliable or that they will prevail over the long term, but most people do.

Another consideration is that more females are entering the labor force, and that this will be a deterrent to child bearing.

On the other side, of course, is the question of the psychology of child bearing under the circumstances. There are few people who believe that we are building up a large pool of women of child bearing age who will not have had a child before they leave the age category, and lose their capacity to bear children. They may yet have children by deliberate choice, a choice that has not been exercised so far. And if that would happen en masse it would have a long-term effect.

So there are a lot of elements under consideration.

But what I think the trustees have done is reflect the general thinking of most people who have given thought to this general subject.

Chairman HUMPHREY. I know that you have to be on the safe side. And I recognize the importance of your views in reference to having observed whatever transitions may have to take place or transitional periods would be required.

Would your actuary like to comment on this?

Mr. ROBERTSON. I would, sir.

As the Commissioner said, if the system were decoupled, so to speak, the long-range cost would be much less sensitive to changes in economic assumptions but it would not have much effect on the sensitivity of the long-range cost to changes in demographic assumptions. We show in tables 31 and 32 of the OASDI trustees' report estimated long-range costs of the present system if it is decoupled in such a way that benefits paid to persons who retire in the future bear approximately the same relationship to their earnings at retirement as currently prevails. In table 32 we show the cost under three paths: Intermediate, optimistic, and pessimistic. And as we said earlier, under the intermediate path there still would be a long-range deficit of 4.28 percent of taxable payroll, which means on the average for the next 75 years expenditures would exceed currently scheduled taxes by 4.28 percent of taxable payroll.

Chairman HUMPHREY. Annually?

Mr. ROBERTSON. Annually, yes.

Now, that is a substantial deficit.

We also show—

Chairman HUMPHREY. That is based on current tax rate and the current earnings base?

Mr. ROBERTSON. Yes, sir, the current ones, but as they are scheduled to rise.

Chairman HUMPHREY. Excuse me, I should say current law.

Mr. ROBERTSON. Current law, but with the benefit formula modified to stabilize the benefits that are paid in the future in relation to pre-retirement earnings.

Now, that is the intermediate assumption, the middle path.

We also show the cost under a combination of more favorable assumptions, as you indicated. If we assume that the real wage growth is not one and three quarters percent, but that it is two and a quarter percent, and if we assume the ultimate fertility rate is 2.3 instead of 1.9—that is an important assumption, because if we assume the ultimate fertility rate is 2.3, that translates into a population which

rises steadily from its level of 223 million persons last year to 360 million persons 75 years from now, a 60 percent increase—we call this the optimistic set assumptions—the long range actuarial deficit would still be 2.64 percent instead of 4.28 percent.

Chairman HUMPHREY. Again based on current tables, current law, rate and earnings?

Mr. ROBERTSON. Yes, sir.

Mr. CARDWELL. In sum, Mr. Chairman, I think we who see ourselves as stewards of the program would urge the Congress to appreciate that probably under the best of circumstances the system as it is presently designed, depending on its present tax structure, lacks financing. That is on the long term. We think financing requirements on a short term are quite different, and clearly manageable. If one looks at the long-term deficit, we would like to believe we should also look at other considerations involving cost to society, and not assume that the only thing to be reckoned with is the cost of dependency for older people, or for disabled social security recipients.

Let's say, for example, that the long-term deficit is hinged, as a lot of it is, on a concept of a declining birth rate, a smaller number of young people and larger share of old. If that does evolve as this picture suggests, then some other things will happen to society. Our dependency costs for young people will surely decline, unless we deliberately enlarge them, because we want to improve the quality of life for these people, or something of that sort. But there are trade offs out there. I think it would be a mistake to only deal with social security, and the cost of social security, and not weigh it against these other considerations.

Chairman HUMPHREY. You are saying that if you have more employment and less unemployment you increase your tax revenues on the one hand and lower your subsistence payments and transfer payments on the other hand, and some of us argue that even if we were trying to create jobs there are some trade offs here, and you are indicating the same thing here.

Mr. CARDWELL. Yes, sir.

Chairman HUMPHREY. I have taken my time.

Senator JAVITS.

Senator JAVITS. Mr. Cardwell, I gather you and your associates come out flat against the idea of the use of general revenues for the social security program as being a solution. And I notice a juxtaposition which may be unwitting, but I would like to know the answer. You will notice at the bottom of the page the full paragraph:

The administration believes in time this would erode the earned right principle that is fundamental to social security. We also believe that it will lead to pressure to further expand the program, and thus increase future cost commitments.

Now, I notice the juxtaposition of the "administration and we." Is that literally true?

Mr. CARDWELL. Well, we are part of the administration. With regard to the question of general revenues, there might be a tendency on the part of Congress at the time they make the decision to authorize benefits, not to decide then and there how they will finance those benefits and the accountable. Thus, there might be a natural tendency to increase the benefits now and ask questions about how it will be financed later.

One of the features that makes social security unique in its financial arrangement for our Government is the fact that the same committees, the same Members of Congress, and the same public policymakers in the executive branch who advocate additional benefits must also at that time explain how they would be financed.

Senator JAVITS. I must say that I thoroughly agree. I wouldn't say that I would never support general revenue funds for social security.

Mr. CARDWELL. I wouldn't want to say that, either.

Senator JAVITS. None of us would as human beings. But I think it would be very bad social, governmental, and economic policy, and I hope we can strictly avoid it.

That brings me to this point. Could you give us a summary of the program you would recommend to Congress in order to deal with this analysis? I gather, just from what you have written here, that decoupling is essential, and you are about, you say, to present us with a decoupling plan. Second, it should be desirable to encourage rather than discourage the continued adherence to the system of State and local employees; is that correct?

Mr. CARDWELL. Correct.

Senator JAVITS. In other words, what else would you encourage us to do in order to keep the viability of the system as it is?

Mr. CARDWELL. Well, our view on the long-term financing picture is that we must eventually develop a permanent financial arrangement that is different from the one we now have for the long term. But frankly, we would not like to see the Government rush into that without further consideration and without examining some choices that in my mind were not previously examined.

I mentioned a minute ago in connection with looking very far out into the future this matter of trying to take account of the broader picture—to examine the social security position in the Nation, and also social tradeoffs with other dependency costs. Those things have never been examined by our planners as far as I know; we, in social security, have not looked at them.

There are issues about the benefit structure that need to be explored. Questions and challenges are before us about whether the system which was designed 40 years ago around the concept of a male breadwinner head of the household should obtain as it was originally designed. There is also the issue of whether the disability benefits are proportionately too high. We find as we look—I am not reaching this conclusion—at a disability today that for a large number of people who have come on the rolls—and we have a very strict definition of disability, you have to be really disabled to become eligible—the benefits levels often exceed the worker's salary.

The replacement rate by private industry standards is very high; it is running in excess of 80 percent. And things like that need to be looked at as we look at the long-term picture. In short, I hate to be on the side of a study, but I think we need to produce some more studies before we lay out the answer to the long-term picture.

In the meantime, though, I would like to reassure the public that we are correcting the flaw in the benefit formula and reassure the public that the reserves will be adequate if emergencies in the midterm do arise.

Senator JAVITS. Let's get the definition of short term, midterm, and long term. Can you reassure the public as to the short term? How long is that?

Mr. CARDWELL. I would say the next 5 to 10 years. And the midterm the next 25 years. When you get past 25 years, you are getting into periods of severe uncertainties.

Senator JAVITS. And also periods of severe differences of view as to assumptions?

Mr. CARDWELL. Right.

Senator JAVITS. So the public can be reassured as to the feasibility of the system for the next 25 years?

Mr. CARDWELL. That is our general thinking; yes, sir.

Senator JAVITS. I think that is critically important, because there has been so much disquiet aroused by the system, and 25 years takes us in round numbers to the end of the century.

Mr. CARDWELL. Correct.

Senator JAVITS. I was interested in one or two other things. One, what do you say about the view of the National Council of Senior Citizens, who are seeking extension of the tax base? They claim as advantages more benefits to more workers, and more workers to include in the coverage, and more progressive program financing, whereas a lower earnings worker would be more heavily penalized by a tax rate increase.

Mr. CARDWELL. I think each of the things you have cited there are essentially correct assumptions about the consequences of a wage base increase. On the other side of the picture—and there is another side—the wage base is increasing under existing law. And it has been increasing at a rate that has been fairly substantial in its impact on workers in that wage class. Now, people argue that these workers are better able to pay than those in the lower range, and that becomes a matter of judgment.

Let me give you an illustration of what would happen in 1977. Maybe this will sharpen the issue. The present law will increase the contribution that a worker has to pay, if he makes \$16,500 in 1977, by about \$70. Other workers below that level under existing law would not pay anything in addition in 1977. The President proposed, in addition to that wage base increase in 1977—under existing law it goes from \$15,300 to \$16,500—an across-the-board tax increase on everybody. Now, that some worker would have to pay an additional \$49, for a total of \$119. A worker making about \$7,500 a year would not have to pay any increased tax because of the wage base increase, but he would have to pay about \$22 more as a result of the tax rate change. A worker at the low range would have to pay about \$12 more.

Our position on the short term is that we should continue a balanced tax imposition and try to spread the load across the work force. If we make a sudden and sharp rise in the wage base, we think we would send a fairly severe shock wave to the people in that salary range. We are not arguing that there is not room to reconsider the tax structure. But we don't think short-term financing should be used as the device for that restructuring. That restructuring should be planned and thought through and related to our long-term considerations in our view.

Senator JAVITS. Now, what do you say to a progressive social security tax rather than the present fixed flat rates on everybody, differing only as to the amount of salary?

Mr. CARDWELL. That is really the basic nub of the issue I just described. I find it awfully hard to come to a flatout conclusion that the present structure is inherently wrong. It is a structure that could perhaps be made more equitable. Its two main features are, it is essentially regressive for the taxpayer. But it is progressive for the same taxpayer when he becomes a beneficiary. And that is where the trade-off is. It is not proportional, and the reason it isn't proportional—that is a choice we could make, we could say, let's make it at least proportional—it isn't proportional because the share of the work force whose earnings are covered by the tax base is less than a 100 percent. And when the program started the coverage was up in the high 90's, and we are now covering about 85 percent. That is a choice.

Chairman HUMPHREY. How do you pick up that extra 15 percent?

Mr. CARDWELL. By raising the wage base more than it will go up under present law. The present law does not raise the proportion. You would have to change the law.

Senator JAVITS. One last question. All your assumptions are affected by peripheral matters, too. For example, when you talked about working women having children, what immediately occurred to me is that under the present day care system in the United States there is one slot for 10 children. Now, in other systems like the Soviet Union, for example, day care is universal. Question: Does that become a weight making factor in the viability of the social security system if we could materially expand, for example, day care, so that working mothers would be better able to have and raise children?

Mr. CARDWELL. I would guess—and I would like to have the actuary comment further on it—that it could have an effect. But I know at this time that we lack the measures in precise terms.

Is that correct?

Mr. ROBERTSON. Yes.

Senator JAVITS. You agree with that?

Mr. ROBERTSON. We couldn't measure the extent to which a day care system would result in an expanded population. But a day care system would encourage women who would otherwise not have children to have them.

Senator JAVITS. And that is an important factor in the effect of social security?

Mr. CARDWELL. I would think so.

Chairman HUMPHREY. Congressman Pike.

Representative PIKE. Thank you, Mr. Chairman.

Mr. Commissioner, I read somewhere very recently that the average social security retiree collects 8 times as much as he paid into the system. I find that statistic a little incredible. And I would like an accurate statistic.

Mr. CARDWELL. We would be glad to give you a statistic for the record.

In looking at the question, you have to look at it in two ranges. As the system evolved, starting back 40 years ago, and up until just about the present time, it tended to pay out substantially more for those who came on the beneficiary rolls than those individuals had paid in.

That was the function of a system that had not yet matured. The system is now approaching maturity, so-called. And that phenomenon should not prevail in the future.

Do either of you have a figure on that?

Mr. ROBERTSON. No, sir, I would not.

Mr. CARDWELL. But it should level out. And we would be glad to give you a figure.

Representative PIKE. My real question, I guess, should it level out at a point where the average retiree collects essentially what he has paid into it plus accrued, let's say, on what he has paid?

Mr. CARDWELL. Less the cost of the—

Representative PIKE. Should it be a break-even proposition?

Mr. CARDWELL. Well, I think one of the reasons it is justifiable to refer to social security as a form of insurance is that it is a system that spreads risk. It works on the law of averages, a concept of projecting mortality, morbidity, and incidents of disability, and incidents of age.

A single individual with high earnings all his life would almost certainly not draw out as much as he would put in, even if he met the most optimistic of all the forecasts.

Representative PIKE. I am sure that this can happen to an individual. But, I am just interested in your view of what the concept ought to be.

Obviously, our surplus would not be disappearing if the payin at the present time were equal to the payout.

Mr. CARDWELL. In theory it should be; the payin plus the cost of administration. The payout should equal payin.

Representative PIKE. I have more concern, frankly, about the figures that you have provided us with than I think the previous questioners are. And I see the surplus disappearing. And I have heard the talk for a long, long time in my congressional career. And at this point what you say is the most essential thing to remove the deficit is not even, I think, in legislative form before the Congress, is that correct; the decoupling.

Mr. CARDWELL. The first step will be before the Congress soon, but it is not yet before them in specific terms.

Representative PIKE. Now, on the figures which you have given us as to the future projections I know what your assumptions are as to demographics and economic growth and inflation.

But, what are your assumptions as to legislation in those cases? Do they include the .6 percent in tax on the employed and the .9 percent new tax on the self-employed.

Mr. CARDWELL. No, sir, they assume the present law.

Representative PIKE. The present law?

Mr. CARDWELL. Yes. We do include in the report analysis of the theoretical effect of a broadly defined decoupling system, and that would reduce the long-term deficit by approximately 50 percent. But, otherwise we assume existing law.

Representative PIKE. I am fully aware of all the political difficulties involved in both the administration and the Congress in doing that which is necessary to stem what I think to be a very severe outflow of funds.

But, I think that the time has long passed and we ought to be moving on the decoupling. If the tax increase is essential, I think we ought to be moving on that. And I am able to look with the same equanimity at your figures that I think you look.

Mr. CARDWELL. I tend to agree with your conclusions, Mr. Pike.

Chairman HUMPHREY. Senator Sparkman.

Senator SPARKMAN. Mr. Chairman, I am sorry I was late coming in. But, I came as soon as I could.

I listened with interest to all the question that have been put to the Commissioner. I am sure that the question I have must have been asked in the beginning.

We read in the papers sometimes things that I just can't understand about social security. One writer would have it going broke next year; and another one said, not next year, but in 10 years; and another one, way off in the distant future sometimes. And then there will be a denial that social security is not going broke, and it is not going to have to draw on the general funds, and so on and so forth.

Is the social security at the present time, and for the foreseeable future, in a stable condition?

Mr. CARDWELL. No, sir, it is not in a stable condition. The system currently and into the foreseeable future, under present law, under the present revenue system in the law, will continue to pay out more than it takes in year in and year out.

We will reach a point—and we estimate that point as sometime around 1980–81—when existing reserves would not be sufficient to close the gap at that point in time between income and outgo.

What would happen after that is something no one knows. We have never had that experience before. Presumably, the Congress would have to provide us with some emergency financing, if that should occur. But, there is no provision in the existing law for any such emergency.

Now, when we say to people that the system is not bankrupt, and that we don't think it is going to go bankrupt, that is on the assumption that the public policy makers will take positive action in time—which is Mr. Pike's point—to avoid a showdown by 1980–81.

Senator SPARKMAN. By what year?

Mr. CARDWELL. 1980 or 1981. For the disability trust fund that slowdown would occur in 1979.

Senator SPARKMAN. Is work being done on necessary legislation to cure those defects?

Mr. CARDWELL. The President has proposed to the Congress a specific piece of legislation for short-term financing relief. He will present to the Congress a detailed proposal for the correction of the long-term defects in the coupling in the system. The two committees in authority seem by appearance at least—and that is all I can relate to—to be saying that there is no need for action at least this year, that there is still ample time to deal with the issues I have described.

Literally, they are probably right. How much time you take, though, I think, depends on one's judgment as to where the low point should be, how long you want to keep the public at uncertainty, and that sort of thing.

Chairman HUMPHREY. Senator Percy.

Senator PERCY. Like Senator Sparkman, some of my questions may duplicate those of others, but I don't think it really matters much. At least you will know that we are not in cahoots up here. And whether we are from Alabama, New York, or Minnesota, or wherever it may be, this is a persistent question put to us. And I don't think my constituents, 11¼ million, will be satisfied until I can say that I have talked directly to you, Mr. Cardwell.

You don't have to take my word for it. I was in Woodstock, Ill., last Friday, dedicating a senior citizens center. It was crowded with hundreds of people, a joyous occasion. But, when one person got up and said, I hear the social security system is going bankrupt, and I hear Ronald Reagan and the Wall Street Journal talk about a deficit in the trust fund of \$2.1 trillion; well, people looked around at each other, and a sudden gloom descended on that room. That joyous dedication turned into a wake.

Mr. CARDWELL. Today's Wall Street Journal has that figure at \$4 trillion.

Senator PERCY. I am not going back to Woodstock.

But, I said this to them—and I wonder if you would back me up—that for your natural life and for that of anyone in this room or for anyone that we know of paying into the social security system today that there would ever be a default. We would fail as a government and as a people to honor the commitments that we have now made. And certainly those in that room, all of whom were senior citizens, had absolutely nothing to fear about commitments not being honored; they had my word for that.

Now, I tried to explain some of the problems. But, can we at least make that assertion, that the social security system is not going bankrupt, that unlike New York City, it will be able to pay its debts? Can we assert that we are going to honor our obligations under this program even if it should be necessary—and I think it is politically inconceivable that it ever would be—that we go to general revenues to avoid default?

Now, am I overstating the case, or do you think I can make that strong a statement?

Mr. CARDWELL. I make the same general statement. But, I also have to add, that this is a matter of perception. Your constituents were testing your confidence. It is really a test of confidence in the Government. And I think you are perhaps asking too much of your constituents to ask them that question and you give them that answer over a long term, because the real proof I think will eventually be determined by what the Congress does. I generally agree with you, though. I can't argue that public policymakers wouldn't continue this program in either its present form or something approximating it. All the industrialized nations of the world have approached the same problem roughly the same way.

But, the Congress would face some very tough choices in solving this problem. You have got to raise additional revenue, or change the benefit structure. And public policymakers are really in a struggle with that choice. And the longer you put it off—I use the term "you" here very broadly, I am not centering on this committee of course—the more its going to cost the taxpayers.

Those who are living today may not have to pay as much, but those who come into play in the future might have to pay more.

There are a lot of very difficult choices. And the press and the concerned public are beginning to realize how tough those choices are. And I think that adds to their doubt.

Senator PERCY. You said in response to Senator Javits that, as I understand it, the system is viable for the next 25 years.

Does that take into account the enactment of the President's 0.6 percent increase in the tax rate? Or is it viable even without that?

Mr. CARDWELL. No, sir, I didn't mean to imply that it is presently viable. The system would face a deficit of slightly under 2 percent of taxable payroll over the next 25 years. The President's tax rate proposal would avoid a deficit until about 1983. And then there would still be a deficit gap between 1983 and the year 2000.

So, there is a problem that must be dealt with even in the 25-year period. But, it is not as severe as the 75-year problem. I think that our capacity to forecast that period of time is better than our capacity for the long term. And I think our capacity to make choices and be able to gage their consequences is better. That is the point I was trying to make. I think if you concentrate on that period, you can probably do a pretty good job of structuring the system and be fairly confident that you have structured it fairly accurately.

The further out you move in your structuring, the more doubt that there is as to whether your choices are correct, or whether the consequences that you now predict will obtain.

Senator PERCY. Obviously the elderly constitute a cross section of Americans just like any other group. There are some highly sophisticated people who can understand all the intricacies of what you have been saying, and others have a tendency to overdramatize the problems. They have got more time to think and brood, and they do, sitting in nursing homes and other places. And they are concerned.

I have said this, that if they are really worried today about a default on their social security benefits, than they might just as well worry about a default on U.S. bonds. Anything could happen. But, it seems to me that, as legislators, in the face of financial difficulty, we would place the highest priority on meeting our long-standing obligations rather than liquidating new obligations and on paying off our bonds and the interest on those. And continuing to pay social security benefits would be so high in priority that I feel no one should have to lie awake nights and worry about the possibility of default.

Now, would you go as strong as I have on that point?

Mr. CARDWELL. I would assume that that is what we will do, yes.

Senator PERCY. And that is a reasonable assumption by reasonable people, you and I both being reasonable.

Mr. CARDWELL. I may make a statement not as Commissioner of Social Security, but as a citizen who has observed the Government and its performance and who has a fairly high degree of confidence about the Government. I am not a cynic about the Government. I believe the Government will do what has to be done. I know that there is going to be a struggle on its way to that objective, because the choices are difficult choices.

Senator PERCY. In your prepared statement you indicate that the President has proposed that the law be corrected by separating the two computations. The separating is what we term decoupling. I understand that a decoupling proposal was promised by Secretary

Mathews for March 1. March 1 has come and gone. And I wonder if you have any explanation for the delay.

Mr. CARDWELL. I don't know about that date. The Secretary, and in fact the President, indicated in January that the proposal would be forthcoming, and gave a general description of its broad proposals. We have been working with others in the executive branch, and for that matter with some consultants for the Congress, on examining specific models. And the President made his choices from those models. And HEW lawyers were given the job of drafting a specific bill. And our deadline that we have been assigned by HEW for that is around June 15. And our assumption is that the Office of Management and Budget and the White House and others will be able to deal with it fairly promptly. They know what the considerations are.

So, I think that the Congress will have a specific bill by about that time.

Senator PERCY. By about June 15?

Mr. CARDWELL. Thereabouts. I don't control it entirely, so I can't make a firm commitment. The drafting itself has nearly been completed.

Senator PERCY. What is the great difficulty in putting this together? I thought we had reached consensus a year ago on the need to proceed with decoupling.

Mr. CARDWELL. There is a consensus about the need to decouple. But, it becomes a very complex matter, because what you have to do is go back in and reconstruct the benefit formula. That immediately raises some questions about whether you want to modify its fundamentals in that process.

For example, you could modify the formula and solve a large share of the long-term deficit by changing the basic benefit structure while you are in the process of decoupling. And one decoupling school says we should use decoupling as an opportunity to solve the long-term problem.

The other school, which is the one that the President decided to follow, says that we shouldn't change the basic fabric of the system in decoupling, we should leave questions about whether we like the system in general to other choices at another time, that decoupling should be centered on correcting a flaw, and then decide whether we want to make other changes in the system.

Following that approach—and that is the approach he has selected—you would cut the deficit in about half.

Senator PERCY. I have just one last question that would require just a percentage figure. May I have permission to ask that?

The size of the trust fund reserve is a question of judgment. Some said as little as a third projected year's benefit payment is OK, and others say 100 percent. Where is the truth?

Mr. CARDWELL. The truth is in the eyes of the beholder. We advocate at least the third. We think the proof of that is that we have lived and operated quite efficiently—we have even gone through a very severe recession and inflationary period with less than 100 percent. We have shown that we can carry the system for 3 or 4 or 5 years with reserves that are below that level. And the third is a matter of judgment.

Frankly, we picked it on the ground that it would represent about 4 months' worth of benefits. And in an emergency it would take perhaps at least that long to do something. There are those who argue that we should have full-funded reserves.

It is a matter of judgment.

Senator PERCY. Thank you very much.

Chairman HUMPHREY. Thank you.

Senator PROXMIRE.

Senator PROXMIRE. Mr. Chairman, I think that the time is getting away from us. I understand that we have a panel of three witnesses following.

Mr. CARDWELL. Incidentally, that panel knows as much about this as I do, these are quite expert.

Senator PROXMIRE. Following some of the questions that I have been asked, there are a couple of points I would like to clarify.

Mr. Pike, I thought, was very helpful in pointing out that there have been allegations that the average recipient has been able to collect eight times as much as he paid in. It seems to me, if you will look at the arithmetic to that, that adds up to about what he should be getting. Here is why.

No. 1, of course, he contributes, and his employer matches it, doubles it.

No. 2, he contributes over a period of 40 years. Presumably what he pays is there earning interest. And the calculations I have indicate that even disregarding any inflation escalation adjustment, I would say, for prices or for wage increases, that just on the basis of matching employer funds and interest, if you figure the interest for 40 years on the average amount that would be invested on this basis, it would come to almost exactly four times as much as he paid in. And then if you allow for the inflation factor, which of course we have been over the last 40 years, which has been aggravated over the last 10 or 15 years, you could justify very easily an eight-fold payback for the social security recipients.

So that, it seems to me, that that would not only be logical, it would also be just and fully justified, and something that a mature system, if we continue to have inflation, at say, 6 percent, you could anticipate.

Furthermore, if you adjusted it further to provide for an increase in social security to reflect increased wages, which presumably would be a little bit more than the increase in prices, you would get an even higher payback.

And then one other point. Senator Percy discussed the prospect of default. It seems to me that it is up to us as members of Congress rather than you to give the answer on that. And there it seems to me that you can give a ringing answer. There are 37 million people, is that right, that get social security benefits.

Mr. CARDWELL. Today between 32 and 34 million.

Senator PROXMIRE. I am a little high; 32 to 34 million people. Almost all of them, or many of them, are voters. In my State, I figure there are 600,000 voters that receive social security. Can you imagine a Senator or Congressman under those circumstances saying, we are going to repudiate that high a proportion of the electorate? No.

Furthermore, we have the capacity under the Constitution, the Congress does, to coin money, as well as to regulate the value thereof. And therefore we have the power to provide that money. And we are going to do it. It may not be worth anything when the recipient gets it, but he is going to get his benefits paid.

Mr. CARDWELL. I tend to agree.

Senator PROXMIRE. Just a couple of other points. Isn't it true—I have heard this alleged—that in other countries that have social insurance systems that general revenues pay something like one-quarter to one-third of the cost? Is that right or not?

Mr. CARDWELL. It varies in other countries. There are systems that have a concept of one-third general taxes and one-third on employees and one-third on employers. Most European systems have some general revenue participation. Some will be specified for certain benefits. But, there is some general revenue participation in most industrialized systems.

Senator PROXMIRE. What kind of inflation assumptions do you make when you calculate the deficit in the social security account? Do you make an assumption that we will have 6 percent, 3 percent, 8 percent?

Mr. CARDWELL. The inflation assumptions we used on the three alternatives for the long term were 3 percent on the most optimistic, 4 percent on the intermediate, and 5 percent on the pessimistic.

Senator PROXMIRE. Supposing you are wrong about that and inflation is considerably higher, what does that do? Does that greatly increase the problem?

Mr. CARDWELL. The most significant economic factor is the productivity factor, the difference between the inflation assumption and the wage assumption. That is the one that really tells the story about how high the costs will go relative to income.

Senator PROXMIRE. So that if wages increase more than prices do, you are better off; is that it?

Mr. CARDWELL. Yes.

Senator PROXMIRE. One more question, Senator Humphrey, the chairman of this committee, has introduced a very interesting bill, and it has enthusiastic support, and it is likely to pass the Congress. It may be vetoed. Or it may become law next year. That is the Humphrey-Hawkins bill. That would be a goal of 3 percent for unemployment. If that does become law and if that goal is achieved, what affects would that have on the social security system?

Mr. CARDWELL. On the very long term—and this is a rough guess—on the very long term we don't think it has a significant effect. Swings in unemployment, though, can have quite a measurable affect on the short term. But, when you spread them out over a long period, other factors start to come into play that offset and compensate the employment and unemployment rate.

Senator PROXMIRE. Why wouldn't that enormously improve, though, the integrity of the social security system and its reliability inasmuch as when you have a recession, such as we have with the 9½ percent or 7½ percent unemployment; the outgo greatly increases?

Mr. CARDWELL. Yes; but higher employment also increases your long-term benefit commitment to those people. Higher employment

seems to employ higher inflation, which also under an indexed system increases cost. But a very rough look at it—and we did anticipate that we would be asked this question—is that in the long term, it probably doesn't come out quite that way. It will have some effect, but relatively little in proportion to the 8-percent deficit as represented at the present.

Senator PROXMIRE. Thank you.

Chairman HUMPHREY. I have a question that Senator Bentsen wanted me to ask. And I want to make one other observation. I am disturbed by the so-called 75-year projections. I just don't think a human being can make those projections. The uncertainties and the many uncertainties that exist can come about in that period of time are just beyond human control, and I think human consideration, particularly when you are talking about fertility rates, and you are talking about the types of employment, and you are talking about population.

This really is something, I think, for people that like to play games with numbers. Twenty-five years; yes.

I am also, may I say, a little bit concerned about a Government that doesn't want any economic planning at all, and yet the Social Security Administration comes in here as part of that Government and says, well, we have got to plan, we have got to look ahead.

And if you would tell Alan Greenspan about your planning I would be appreciative, because it is perfectly obvious that we can't go on a year-to-year basis, that we have to look down the road. And I agree with you. And I think a 25-year span is a very big span of time in a fast changing society such as ours in which life styles change, and in which all kinds of technological changes are taking place, and work patterns change.

So, what I worry about is that the so-called bad news of the 75-year projection frightens the living daylights out of people. If anybody can really project for me with any certainty what is going to happen in the next 25 years, I would tell you that you would be a very famous man. But, I think you have an obligation to try to look ahead in time of your actuarial soundness or the solvency, to put it another way, of the system. I am not unmindful of that.

I just want to also add that there isn't any doubt that unemployment has had an effect upon the deficit position of the system now; isn't that a fact?

Mr. CARDWELL. There is no question about the short-term effect.

Chairman HUMPHREY. So, if you could get unemployment down, for example, in your assumptions, on intermediate, you assume unemployment at 5 percent?

Mr. CARDWELL. For the long term; yes. It is somewhat higher for the short-term assumptions.

Chairman HUMPHREY. If you could get unemployment down to 4 percent, it would have some wholesome effect; wouldn't it?

Mr. CARDWELL. I think so; yes.

Chairman HUMPHREY. So even though you may take it for the long term that it doesn't have as much effect, at least in the interim period, the next 5 to 10 years, it surely would have some effect; is that not right?

Mr. CARDWELL. Yes, sir.

Chairman HUMPHREY. I am just trying to put it in balance. Just as you said, we are not sure what family sizes will be. And you brought up the possibility that women in the work force may decide that there comes a time that there will be in a sense planned parenthood, that they decide whether they will have a child. And that can also make some difference.

The Wall Street Journal has an article today that talks about the 4 trillion more or less. They occasionally indulge in hobgoblin, frightening stories. But this one of course is based on that 75-year projection. And it also is based upon the fact that there is no decoupling. And I think both you and I recognize that there is going to be decoupling.

Mr. CARDWELL. I think so; yes.

Chairman HUMPHREY. I don't think there is any doubt about that. There is Gretna Green agreement on it.

Mr. CARDWELL. I know of no opposition to that idea anywhere.

Chairman HUMPHREY. So, I am only saying that a responsible paper like this ought also to give the alternatives, so that when somebody is sitting out there on their front porch and looking ahead—of course, whoever is getting social security benefits in 1976 really ought not to be losing much sleep about what is going to happen 75 years from now.

Mr. CARDWELL. He shouldn't lose any at all.

Chairman HUMPHREY. And I do believe that it has been quite clear today—and I think Senator Proxmire hit it right on the head—when you have 600,000 voters in Wisconsin and about the same number in Minnesota, and a 3,300,000 in Illinois, there isn't any doubt but what the elected representatives of the people are going to see that this system is capable of meeting its obligations. That does not mean that we should not review it in terms of tax structure, earning base, benefits and all that is in it. And I am concerned about the disability fund. I think this hasn't given enough attention.

Mr. CARDWELL. I think you are right on the target in your last remarks.

Chairman HUMPHREY. And Senator Bentsen's question—I don't really know what the basis for it is, but I will ask it.

Mr. CARDWELL. Would you recommend the course taken last year by the Social Security Advisory Council as the solution of the problem of benefit levels projected for the next century? Are you aware of what that is all about?

Mr. CARDWELL. Yes; I think I can generally describe it to you. The Advisory Council concerned itself with the same issue that we discussed today. They indicated that there was a need for both short-term intermediate financing adjustment and some permanent long-term adjustment.

In looking at permanent long-term adjustment they recommended the consideration of two possibilities.

One, specifically they suggested that you might reasonably remove medicare from the dedicated tax part of the system on the argument that medicare is the one benefit that is not directly related to the tax. The other one—on which they did not include a specific recommendation—was to call to those of us who have to look at the thing over the long term the possibility that if we are going to have a declining

workforce, we might want to look at the retirement age, and it might even be necessary to consider adjustment in the retirement age.

Chairman HUMPHREY. What is your view about removing medicare, the payment on the trust fund?

Mr. CARDWELL. I would not elect that choice right now. I think I would want to look for awhile on what we are going to do on the broader question of national health insurance or some other system. I think this should be looked at as we look at the long-term picture I wouldn't consider it in the short-term at all.

Chairman HUMPHREY. The second question Senator Bentsen asked me to put to you is this. Does the information available to you indicate that the so-called wage index model stabilize replacement rates in the future?

Mr. CARDWELL. Yes, sir. He is talking about decoupling.

Chairman HUMPHREY. Yes.

We do have a panel. But, I don't like to have your associates leave without comment if they have anything further they might want to say.

Mr. CARDWELL. We have our fair share, and we would like to make way for the panel.

Chairman HUMPHREY. We thank you. We appreciate your complementary help here.

I have already introduced our next witnesses, and I will just call them to the witness table: Mr. Robert Ball, the former Administrator of the Social Security Administration; Mr. Nelson Cruikshank, Miss Harriet Miller.

And we are especially pleased to have Mr. Ball with us this morning. For the record, he served as Commissioner of Social Security from 1962 to 1973, and has always been willing to assist us in understanding the complex problems that face the social security system.

Mr. Cruikshank and Miss Miller represent associations of retired persons, the current beneficiaries of social security, and have a direct interest in seeing that the integrity of the social security system is maintained.

We will hear first from Mr. Ball.

STATEMENT OF ROBERT M. BALL, SENIOR SCHOLAR, INSTITUTE OF MEDICINE, NATIONAL ACADEMY OF SCIENCES; AND FORMER COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. Chairman, I have a rather long statement here that I would like to submit for the record and summarize it, with your permission.

Chairman HUMPHREY. It will be incorporated in the record.

Mr. BALL. There is one place in the statement where a "not" got in where it shouldn't have.

Chairman HUMPHREY. Where is that?

Mr. BALL. I make the point that most foreign systems have a government contribution, but unfortunately it came out that they do not have. And I would like to take that "not" out.

Chairman HUMPHREY. We will correct that.

Mr. BALL. Mr. Chairman, I am going to leave out almost all the background that is included in my statement, because to a considerable

extent it is overlapping with the Commissioner's statement, and concentrate on what seems to me the essential differences, and give emphasis to the points that seem to me might best be called to your attention.

I would like to say, first of all, that I think what social security is faced with is not truly a danger in the sense of social security benefits not being paid either to present beneficiaries or the present contributors. I have every faith that the Government will take the necessary steps to see that all obligations under this insurance system are met. Anything else would be unthinkable.

But I do think that we are faced with a crisis of confidence at the moment, with the press and the television playing up reports about both long-range deficits and short-range deficits. And I would like to urge with all the force at my command, Mr. Chairman, that the Congress act promptly to change the law in such a way that that confidence can be reasonably restored.

I think it is a very dangerous matter to have people continue to feel that there is a danger of social security not meeting its obligation. I have made a series of very specific proposals to restore confidence in the financing of the system.

Chairman HUMPHREY. What page are those on?

Mr. BALL. They are scattered through, but summarized in the conclusion.

Chairman HUMPHREY. Just go right ahead.

Mr. BALL. First, let me support 100 percent of the administration's proposal to decouple the system. The objective, on the basis that they are proposing it, which I think is the correct basis—and incidentally, the proposal is embodied in a bill introduced by Senator Bentsen some time ago—is to make sure that people in the long run get the same proportion of their recent earnings when they retire as people do today. Half of the long-range actuarial imbalance we have been hearing about comes about because under certain wage and price assumptions under present law, people 50 years from now would come on the social security rolls eligible for benefits that were higher than any wages they have ever earned. Well, that is ridiculous.

Nobody is going to let that happen. But, it seems important, nevertheless, to take the steps now that prevent these huge deficits from ever being estimated again, and ever showing up again in the Wall Street Journal as a \$4 trillion figure. Because you can reduce half of the estimated long-range deficit in a very sensible way that really helps the contributor by making sure what he is going to get. The administration's proposal and Senator Bentsen's proposal take the gamble out of the situation; they guarantee that the return in the future will get the same relative benefits that people retiring today are getting.

I would like to digress here for a moment to say that the President has recommended doing this, and Senator Bentsen has introduced a bill for doing this, in a way that I think should be broadly supported. And that is to stabilize the replacement rate.

There are proposals about—and I understand that very shortly there will be proposals made to the Senate Finance Committee and the House Ways and Means Committee—that, instead of stabilizing the replacement rate try to solve the financial problem in social security by mak-

ing it a less adequate system for people now contributing by promising in the future a much lower ratio of benefits to wages than is being paid people retiring now.

Obviously, you can balance the system if you cut back on relative benefits. I think that is a very dangerous proposal that needs to be weighed very carefully. The President has proposed that the replacement rate be stabilized and I would expect that the Congress would not want to do less.

Chairman HUMPHREY. That is the Bentsen bill, is it not?

Mr. BALL. That is the Bentsen bill. There may be details in Senator Bentsen's bill that may need to be changed when the administration bill is considered, but the thrust of the Bentsen bill is the same.

And it has the wide support of labor and senior citizen groups and the last advisory council on social security.

So, let's take decoupling for granted and not talk about these huge deficits without realizing that at least half of the long-range problem is unreal.

Now, as far as the immediate problem is concerned, it is quite true that if all we were talking about was an excess of outgo over income for a few years, you would not have to take any action. That is what the trust funds are for; to see us through a recession period like this. It is helpful to the economy right now to be paying out more than we are taking in.

But, that is not all there is to it. It wouldn't give me concern if it were just a year or two of excess of outgo over income. The problem is, as the Commissioner indicated, that the annual deficits continue on year after year. And let's not worry at this point in this discussion about the next century that is more problematical. But, there is clearly a short fall in social security financing for the next 25 years of around 15 percent on the income side.

So, what I would argue is, you decouple the system—stabilize the replacement rate—the point I have already made, and you do it right away. Then I would disagree very strongly with the administration on how to meet the short-run deficit. I do not believe the best thing would be to increase the contribution rate 0.3 of a percent on all employees and employers. I think it would be preferable to increase the maximum earnings base gradually beyond what would happen under present law automatically as average wages rise.

When this system first started back in 1937, the full wages of 97 percent of the workers covered by the program were under the system. Now, that means they paid on all their earnings, and it means that they got benefit credit for all their earnings. Today only 85 percent have all their earnings covered. If we can work our way back to a higher figure of, say, 95 percent of all the workers having all their wages covered, that would make a significant contribution to the long-range financing problem; it would reduce the long-range actual imbalance, and it would also be a direct substitute for the President's proposal to increase the contribution rate in the near term.

Now, that does not in itself carry you through the next 25 years. But, there is in the present law a contribution rate increase written right into the Social Security Act for the year 2011, a 1-percent increase. That was put in because of the recognition of the possibility

in the next century of an increase in the number of older people compared to those of working age. The 2011 rate increase was put in the law in order to bring about an actuarial balance under the assumptions used at the time of the 1972 social security amendments.

What I would propose to do is to move that rate up, move it up to the point where the higher wage base that I recommended would not be enough to keep the system in the black. I would guess that would be somewhere in the mid-1980's or late 1980's.

So, with those three actions: Decoupling, gradually increasing the earnings base to get back to where we were, and moving up this higher contribution rate, the system would be fully financed through the rest of this century. In addition, you would have reduced the estimated long-range imbalance by more than 50 percent.

Chairman HUMPHREY. Just so I get it clear, Mr. Ball, as I understand it, in the beginning some 97 percent of all wage earners and wages were covered by social security?

Mr. BALL. Ninety-seven percent of all wage earners had all of their earnings covered.

Chairman HUMPHREY. Had all of their earnings covered?

Mr. BALL. And that amounted to about 95 percent of all the payrolls in covered industry.

Chairman HUMPHREY. And now it is 85 percent?

Mr. BALL. Yes. And I think we ought to work back to where it was.

Chairman HUMPHREY. So, your proposal is to gradually move the wage back up to that figure of 95 percent?

Mr. BALL. Yes. A very specific proposal for consideration. Mr. Chairman, would be the following: Every time the wage base rises automatically, just write into the law that you would raise it by an additional, say, \$2,500 or \$3,000, until you go back to the 95 percent point. And remember, all we are saying is that higher wage earners ought to pay the same percentage of their earnings as low wage earners.

How can that be considered anything but fair? It is not even a progressive rate. It is just the same rate for all. Now, a person earning \$20,000 in paying a lesser rate than a person earning below.

So, with those changes taken together we will be in good shape through this century.

I do not want to completely dismiss, Mr. Chairman, the possibility of additional problems for the system in the next century: Obviously it is speculative whether there will be such problems. And there are many ways in which they can be dealt with if they arise.

But, we do not know this much. There will be an increase in the number of elderly people. The people have already been born, and by applying a relatively conservative mortality rates to this population it is clear that in the period between 2005 and 2030 we will be faced with a very sudden and large increase in the elderly population.

Now, what we don't know is the size of the working group who will be contributing to social security. That group is determined by the fertility rate, by the extent to which women and the elderly participate in the labor force, and so forth. It is the relationship of the size of the elderly group to the labor force that determines the cost of social security as a percent of payroll.

I would just like to close, therefore, by saying that there are very reasonable specific proposals that would finance social security

through the rest of this century, and to restate my complete confidence that the Government of the United States will back the insurance obligations to the contributors. Then I would add that I don't think it is too early for us to start thinking about retirement policy in relation to their being a very large group of elderly people in the next century.

It is one thing to support an adequate retirement system—social security and private pensions—and adequate care for people in their own homes or in nursing homes and other proposals to help the elderly, if, under conditions of a very large elderly population, we are going to have people work generally speaking up to 65 or even somewhat later. But it is something else again if we are going to pursue a policy of people retiring at younger and younger ages and leaving the labor force at 60.

There is no escaping that fact. It is not just a social security problem; it would be a problem no matter how you approach caring for the elderly. If we have a policy of retirement at young ages, there will be a greater burden on active workers under conditions of a large increase in the elderly population in the next century.

So, I would urge real attention to increasing employment opportunities for older people as we get back to full employment. At that point, I think we ought to take a hard look at compulsory retirement age policy and second career possibilities. These are matters that could be of great importance in the next century, Mr. Chairman.

[The prepared statement of Mr. Ball follows:]

PREPARED STATEMENT OF ROBERT M. BALL

Mr. Chairman and members of the committee: My name is Robert Ball and I am now a Senior Scholar at the Institute of Medicine of the National Academy of Sciences. From April 1962 until March 1973 I was Commissioner of Social Security and prior to that served for approximately 20 years in various positions in the Social Security Administration and its predecessor organization, the Social Security Board. I am testifying today as an individual, and my opinions do not necessarily represent those of any organization with which I am associated.

INTRODUCTION

Social security today is of major importance to just about every American family. Practically every American is either a beneficiary, a contributor building future protection, or the dependent of a contributor. Today 92 percent of the people 65 and older are eligible for social security benefits. Ninety-five out of 100 young children and their mothers are protected by the life insurance features of social security, called survivors' insurance. Four out of five people in the age group 21 through 64 have protection under social security against loss of income due to severe disability. More than 32 million people, one out of seven Americans, receive a social security benefit each month. About 104 million people will pay into the program this year.

The government through social security has promised future protection to all these people in return for specific earmarked contributions, or premiums, paid by the workers of the country, their employers and the self-employed. I have no doubt that these promises will be kept, but, as you all know, doubt about the financial security of social security is growing among the millions and millions who must depend on the system. An erosion of public confidence is taking place, and unnecessarily. Although there is a short-fall in social security financing under present law, it is correctable. Steps can and should be taken now to restore the financial integrity of the system and to assure people that their social security protection is safe.

THE NEXT FEW YEARS

Social security paid out \$1.5 billion more than it took in in 1975, and will pay out about \$4.3 billion more than it will take in this year. In itself this is

not a cause for concern. The Trust Funds exist for just such a situation, and in a recession period it is good for the economy that social security is paying out more than it is taking in. The difficulty is that, in all likelihood, unless the financing of the system is strengthened, outgo will continue to exceed income year after year. There can be reasonable differences of opinion about the size of the annual deficits, but not about the fact of the deficits themselves.

Personally, I have no quarrel with the estimates for the next five years just released by the Boards of Trustees as their "best" estimate. These estimates show an excess of outgo over income for 1977 of \$3.9 billion; 1978, \$5.2 billion; 1979, \$5.9 billion; 1980, \$7.2 billion; and 1981, \$8.6 billion. However, under even much more optimistic assumptions, the shortfall is still: 1977, \$3.9 billion; 1978, \$4.3 billion; 1979, \$3.5 billion; 1980, \$2.2 billion; 1981, \$2 billion. Under the first set of assumptions the cash benefit Trust Funds are exhausted in 1982 and under the second set of assumptions about 1986. A return to full employment and to much lower levels of inflation, while, of course, very helpful to social security financing, will not be enough alone to fully solve social security's financial problem. There would remain a middle range problem over the next 25 years and the possibility of a longer range problem in the next century.

If all we were faced with was a short run year by year deficit, which would correct itself with economic recovery, the obvious course would be to do nothing. As it is, it seems to me important, just as soon as possible, to amend the law to meet that part of the problem that can be clearly foreseen—the shortfall over the next 25 years—and so restore public confidence in the integrity of social security financing. I do not believe that it is important that the amendments have a major immediate impact, but the changes should be made now so that people are reassured. Social security is too important to the welfare of all to allow doubt about its fiscal soundness to continue. Congress can act now, but in a way that has a minimum negative effect on either employment or prices. But before making a specific proposal for action let me remind you how we got to where we are.

THE BACKGROUND OF THE SOCIAL SECURITY FINANCING PROBLEM

When the social security amendments providing for automatic cost-of-living increases were signed into law in 1972, the system was thought to be adequately financed. There is no truth to the notion that Congress has been willing to vote benefits but not financing. Congress has been very responsible about social security financing. The 1973 reports of the Boards of Trustees issued shortly after the 1972 amendments showed an imbalance over the 75 years for which estimates are made somewhat larger than had been expected at the time of the legislation—an imbalance of about one-third of 1 percent of covered social security payroll. (What is meant by this is that an increase in the contribution rate of one-sixth of 1 percent for the employee and a like amount for the employer would have brought the system into exact balance.) Revised estimates made in the fall of 1973 showed a significant increase in the imbalance—to over three-fourths of 1 percent. In the 1973 amendments, the Congress not only speeded up the cost-of-living benefit increase for 1974, but also brought the long-range imbalance down to a level of about one-half of 1 percent of covered payroll. This was an imbalance of about 5 percent relative to the cost of the whole program over the 75-year period. This relatively minor degree of imbalance was considered acceptable by the Congress, considering the major uncertainties attached to such long-range estimates.

Moreover, under the estimates it was expected that, in any event, income would exceed outgo year by year far into the future, and that any possible adjustments could be made well before the time they were needed.

The recession has changed all that. It now appears that because of the recent rapid rate of inflation which caused increases in benefits under the automatic provisions, while at the same time unemployment has caused a drop in estimated revenues, there will be a need for more income to the system during the next 25 years than had previously been thought to be the case. A contributing factor in this deficit is that the disability insurance program, on the basis of the last five years experience, is now estimated to cost substantially more than it was previously estimated to cost.

As already indicated, the deficit caused by the recession does not disappear with economic recovery: All benefit payments in the future will be higher

because of the inflation of the past, and the system can not make up for lost revenue because interest on the shrunken reserves will be lower than previously expected.

WHAT SHOULD BE DONE

1. Change the automatic provisions in present law so as to stabilize the replacement rate

The introduction of the automatic provisions in social security in 1972 was a major accomplishment. Beneficiaries are now protected against inflation and contributors receive automatic improvements in their protection, adjusting for both inflation and the rising level of living of the community as a whole. There is, however, a problem in the design of these automatic provisions. As they are written, under some wage and price assumptions benefit protection rises proportionately as wages rise, thus, keeping up to date with the level of living as originally expected; under other assumptions, in the long run, the benefit protection may rise less than wages rise; or, under other assumptions—such as those assumed in the latest reports of the Boards of Trustees—much more than wages rise, resulting in the completely unrealistic situation in the 2030 to 2050 period of many people becoming eligible for social security benefits at the time of retirement higher than any wages they ever earned. It all depends on the happenstance of how wages and prices move. (When these provisions were adopted it was assumed that the wage and price pattern of the previous 20 years would continue, and under those patterns, protection would have increased approximately with wages, but under recent assumptions this is not the case.)

The automatic benefit provisions should be changed in such a way that benefits paid in the long-run future are the same proportion of recent earnings for those who retire at that time as benefits are today for those retiring today. In other words, the "replacement rate" should be stabilized. This means that benefit protection for contributors would be guaranteed to keep up to date with increases in wages but not allowed to exceed such increases. Once on the rolls, the purchasing power of the benefit would be guaranteed as under present law.

Such a change in the automatic provisions is desirable, in any event, because it removes the gamble for current contributors and provides a level of protection they can count on. In addition, because of the specific wage and price assumptions which have been used in recent cost estimates, such a change would also have the effect of reducing the long-range (75 year) actuarial deficit by almost one-half. This change was recommended by the President in his budget message, and, I am glad to learn that the Administration now estimates that it will submit legislation to carry out this proposal by the middle of June.

There is widespread agreement that the automatic provisions should be changed in this way. The last Advisory Council recommended this change, organized labor supports this change, so do senior citizens' groups, and, as I have indicated, so does the Administration.

For those retiring in the future or becoming eligible for survivors' or disability benefits in the future, the automatic provisions of social security, modified to stabilize the replacement rate, will in most instances provide reasonably adequate benefits for middle income and lower paid workers who have worked continuously under the program. It is expected, however, that the high paid will need supplementation from private pensions in order to maintain a level of living in retirement at all close to that enjoyed while working. Today a worker who has been getting the maximum earnings counted toward social security will receive a benefit equal to 33 percent of his earnings in the year before retirement. For a husband and wife the replacement rate would be about 50 percent. For a worker earning the median wage for male workers the rate would be about 45 percent for the single worker and 68 percent for the couple. Comparable figures for the worker earning the Federal minimum wage would be 61 percent and 91 percent.

Now the future for the retired aged is not quite as good as this sounds. More than half the retirees claim benefits before age 65, and are disadvantaged in two ways: Their benefits were actuarially reduced (as much as 20 percent if they retire at the earliest possible age of 62), and their average earnings, on which benefits are based, may be lowered because of the failure to have earnings between 62 and 65. And, if workers are out of a job, or for any reasons are not covered under social security for a total of more than 5 years during their working career, their benefits will also be less than indicated.

Mr. Chairman, at this point, perhaps it would be worthwhile to digress slightly in order to say why I do not believe that in changing the automatic provisions the Congress should give consideration to the possibility of reducing the replacement rates in present law. It is true, of course, that if benefit levels in the future were to be smaller relative to wage levels in the future, the system would cost less as a percent of covered payrolls. In other words, the financing of the system could be balanced by the device of reducing benefits relative to wages, but it would be at the cost of making the social security system inadequate for the young people contributing today. I bring this up because I understand that such a course will be suggested by a panel of actuaries and economists who will soon be reporting to the House Committee on Ways and Means and the Senate Finance Committee.

I believe this approach would be unwise. Present replacement rates are certainly not excessive, and the ratio of social security benefits to previous earnings more than anything else determines the income security of older people. Even in the long run, probably 40 percent of retired persons over 65 will be dependent on social security alone for a regular retirement income. About 10 percent will find that social security is not enough and will need help in addition from the needs-tested Supplemental Security Income program. Another 45 percent may get both social security and some retirement protection through either private pension or government career plans. Perhaps 5 percent, under present policy will get only a government career pension.

Any reduction in social security replacement rates would surely mean inadequate protection for the 50 percent or so who would not have additional protection under private plans or career government plans, and probably also for many of those with private pension plan supplementation. For others with private pension supplementation, total protection could be maintained only if pension plans were to be further liberalized to make up for any cut-back in social security.

It is noteworthy that the President recommended that the present wage replacement ratios be maintained when changes are made in the automatic provisions. Surely, the Congress would not want to do less. I hope that the Congress will pass legislation to stabilize the replacement rate promptly in order to protect benefit rights and, at the same time, reduce the actuarial imbalance shown in the present estimates.

2. The maximum amount of wages counted for benefits and contributions should be gradually increased more than provided for by present law

I do not favor the President's proposal to increase the contribution rate by 0.3 percent on all employees beginning January 1, 1977. A rate increase falls on all wage earners, low paid as well as high paid, and no one gets additional protection for their additional contributions. Moreover, the full economic effect of such an increase would be felt immediately at the beginning of the year.

Instead, I favor a gradual increase in the amount of earnings counted for benefits and contributions. Only the 15 percent of wage earners who have earnings above next year's maximum of \$16,500 a year would pay more under this proposal, and they would also receive more in benefits.

A short-run advantage of increasing the maximum earnings counted as against the contribution rate is that the economic effect of the increase in the maximum earnings is largely postponed until toward the end of the calendar year. In 1977, for example, until late in the year, very few workers would earn more than the \$16,500 that would be covered in 1977 under present law. Although the provision needs to be passed the year before, and be effective the first of the year, it has almost no economic impact until the last 2 or 3 months of the year.

I would hope that the Congress would pass legislation this year that would provide for a gradual increase in the maximum amount of earnings counted. The first step could be made effective in 1977 or even in 1978 and the increases could be quite gradual—say \$3,000 a year more than under present law—until the program once again covered the full earnings of all but the very highest-paid earners, as was the case when the program started in 1937. At that time, 97 percent of all those in covered occupations had their full earnings counted for social security. As already indicated, the maximum earnings base of \$16,500 in 1977 will cover the full earnings of only about 85 percent of those in covered occupations. Such a change would not only contribute to a solution of the short-run problem, but would reduce the long-run actuarial deficit.

3. The contribution rate increase of 1 percent now scheduled for 2011 should be made effective earlier

The present law contains a contribution rate increase of 1 percent scheduled for the year 2011, a rate increase which was designed to deal with the problem

of a higher ratio of retirees to workers in the next century as compared with this century. I would propose that that rate increase be moved up to the point—probably in the late 1980's or early 1990's—when, after the changes already indicated, the outgo of the system would otherwise once again exceed income.

In summary, the result of the increase in the wage base and moving up the contribution rate already scheduled in present law, together with stabilizing the replacement rate would carry the social security program into the next century, and under the assumptions used in recent trustees' report would reduce the long-range actuarial imbalance by over one-half. This would be accomplished without increasing the contribution rates over those already scheduled in present law and without recourse to any new sources of financing.

I want to stress that two of the three changes I am suggesting for dealing with the financing problem over the next 25 years are desirable in terms of benefit protection, really without regard to financing. The substantial improvement in financing is a by-product of improving program protection.

It is desirable to guarantee that benefit protection will rise as wages rise, but it is not desirable to have automatic provisions that could result in social security protection rising at a faster rate than wages. If such an improvement in the relative level of benefits is desired, it should be by specific congressional enactment. Increasing the amount of earnings counted for benefits and contributions would make the financing of the system more progressive, and would improve protection under social security for those called upon to pay more and who now have quite low ratios of social security benefits to past wages.

There are, of course, other possibilities for meeting the deficit over the next 25 years. It would be possible to do it entirely by increases in the contribution rates, combining the President's proposal with moving up the 2011 rate as I suggested. Another possibility would be to tax employers on their total payrolls and increase the maximum earnings base for workers somewhat less than suggested earlier. The values of the contributory system are preserved by relating deductions from workers' earnings to benefit credits, but the employer's contribution does not need to be related to the benefits of individual workers. The employer's contribution can be thought of as a resource for the system as a whole.

Then, too, there are possibilities of various combinations of these approaches. The contribution rate might be increased, say half as much as proposed by the President, rounding the contribution rate, including Medicare, from 5.85 percent up to 6 percent, with a lesser increase in the maximum earnings counted.

A still further possibility would be to introduce a general revenue contribution into social security in the near future. Most foreign systems have such a government contribution in addition to deductions from workers' earnings and payments from employers. I would favor a contribution from general revenues in the long run if it turns out to be needed to meet the long-range costs of the present program or of an improved program. However, with all the other current pressures on general revenues (including the need for general revenues to finance part of a new national health insurance program and improvements in other social programs), it seems to me best to meet the financing deficit in social security for at least the next 25 years or so, without turning to the general treasury.

THE EFFECT OF SOCIAL SECURITY CONTRIBUTIONS ON LOW WAGE EARNERS

I believe it would be a mistake to exempt low-income workers from social security contributions or to base social security financing on progressive income tax principles. Social security grew out of the efforts of people to help themselves. Its roots go back to contributory plans in the medieval guilds and to trade unions, fraternal orders, friendly societies, and insurance plans—self help efforts. Although I support the use of general revenues for social security to finance part of the cost of the system in the long run, if needed, it seems to me that proposals to finance social security entirely from general revenues or from some kind of income tax surcharge which would completely exempt low-wage earners are based on a failure to understand the strengths of the self-help philosophy. If financing were related entirely to ability to pay, it is very likely that benefits, in time, would be related to need. Thus, as a result of a change in financing, we could find that social security had been turned into a welfare program designed to help only the very poor, and that it was no longer a self-help program serving as a base for all Americans to use in building family security.

Moreover, the security of future benefit payments is greatly reinforced by the concept of a dedicated social security tax or contribution paid by the people

who benefit under the system. The moral obligation of the government to honor future social security claims is made much stronger by the fact that the covered workers and their families who will benefit from the program made a specific sacrifice in anticipation of social security benefits in that they and their employers contributed to the cost of the social security system, and thus they have built a right to expect a return in the way of social security protection.

Although I believe that this right can be protected even though general revenues share in the cost of the program, it is important to preserve the principle that a significant part of the program be financed by direct deductions from the earnings of all covered workers. The general revenue contribution, which might be needed in the next century (or earlier if benefits are substantially improved) can well rest on the rationale of paying for that part of the program which is not directly wage related—the social element in giving a weighted benefit to those with low wages, those with dependents, and those who were no longer young when the program started.

There is a real dilemma, though, as far as the low-wage earner is concerned. He may be getting a "bargain" for his social security contributions—as he does—in terms of long-range retirement, disability, and survivorship protection, but nevertheless questions can be raised about a social policy that forces him to substantially reduce an already low level of current living in order to secure this protection. A possible solution to this dilemma would be to make the refundable earnings credit in the 1974-1975 tax bill permanent and to broaden the credit to include low-income workers without children. Under this provision, low-income people get either an income tax credit, or if they do not have to pay an income tax they get a positive payment offsetting a considerable part of what they are required to pay for social security. Yet the provision does not change the social security system. It is a subsidy from general revenues to low-income workers based on their total family income and the number of people dependent on that income.

IS THERE A REMAINING SOCIAL SECURITY FINANCING PROBLEM IN THE NEXT CENTURY?

If the three steps I recommend are taken, would there still be a deficit in social security financing in the next century? The answer is that no one knows, but there is some possibility—even likelihood—that this will be the case. The reason is that we may have an increasing ratio of retired persons to working persons—more taking out of social security as compared to those paying in. This is a situation that, given recent trends, might begin to occur about the year 2005.

While the growth of the population 65 and over since 1900 has been very large and quite steady—rising from 3.1 million in 1900 to 23 million today, an average increase of more than 30% every 10 years—future growth will not be a straight-line projection of the past. After 1980, the rate of increase begins to drop sharply, so that it takes over three decades for another 30 percent increase, with the population over 65 reaching a total of about 31 million people in 2005. Then, as the generation born in the post-war "baby boom" reaches retirement age, the numbers will shoot up from 31 million to 52 million in 25 years. And this is quite certain. This group has already been born, and its size has been estimated on the assumption of only modest improvements in mortality rates.

Thus, the problems up to about 2005 are largely unrelated to demographic factors, but after 2005 the key question will be the size of the labor force, the number paying in. On this point there is considerably less certainty than there is about the number over 65, because the number in the labor force depends most importantly on future fertility rates, and the extent to which women and older people work.

Fertility rates dropped steadily and dramatically from 1957 to 1974. In 1957 it was estimated that on the average women would have 3.77 children. By 1965 the rate was 2.93; by 1970, 2.48; and in 1974, 1975 and 1976 it has been about 1.8. In other words, women are now expected to have only half as many children as they were expected to have in 1957.

With considerable justification, therefore, the last three trustees' reports have assumed for the long run that the fertility rate in the United States will not be 2.5 as had been assumed in the 1973 trustees' report, the last to show social security in approximate long run balance. In 1974 and 1975 it was assumed rather that the rate would rise slowly and stabilize at 2.1 which is approximately the rate that, over time, will produce zero population growth. (I can see nothing, however, in the developments of this last year that caused

the trustees in the report just issued to change to an ultimate rate of 1.9 for the central assumption. For this and other reasons it seems to me that the long-range cost estimates in Appendix B of the new report, modified to assume a stabilization of replacement rates should be the focus of our attention rather than those appearing in the body of the report.)

The results of changing from a 2.5 fertility rate to an ultimate rate of 2.1 are startling. In 1940 there were 77 million persons in the age group 20-64 and 9 million people over 65, a ratio of 11.7 aged persons for every 100 persons of "normal working age". Comparable figures in 1974 were 120 million and 22 million, for a ratio of 18.3 aged for every 100 persons of "normal working age". Under the changed assumption there are only minor fluctuations in this ratio between now and 2005, but at that time the growth in the age 20-64 population comes to a halt just at the time the number of people aged 65 and over shoots up from 31 million to 52 million in 25 years, resulting in a ratio of about 30 people past 65 for every 100 persons 20 to 64. But how certain is the continuation of these low fertility rates for the long run?

If we look not at the period just since 1957, but, say, over the last 75 years, these have been many ups and downs in the fertility rate in the United States. It was high at the turn of the century, dropped sharply at the beginning of the depression of the 1930s, began to rise during World War II, and remained on the rise until 1957. If the fertility rate were to rise quickly to 2.5 again, there would, of course, be no long-range social security financing problem of the type now anticipated.

Population experts have, on the record, not been particularly successful at predicting fertility rates, and in that sense everyone can take his choice on the basis of past experience. Yet it may be imprudent to count on there being a return to the fertility rates of the late 1960s and 1970, and in this way dismiss any long-range social security financing problem. The widespread knowledge about, and availability of, inexpensive (for the United States) methods of contraception, the tendency to prefer a higher level of living made possible by a smaller family, and the widely recognized major social reasons for zero population growth, persuade me that it is reasonable to base projects of social security costs on a fertility rate ultimately producing ZPG. If we are going to have such fertility rates, we ought to start thinking about the retirement policy that makes sense under ZPG conditions because the most significant social trend causing higher than necessary social security costs in the next century is the trend towards earlier retirement.

In the last trustees' report, the trustees have assumed a continuation of this trend and have estimated a further long-range reduction in labor force participation on the part of people over 60. If we could instead, have greater labor force participation among older people in the next century than we have today, there could be a significant saving for social security over what is currently estimated.

There may well be a question whether a policy of earlier and earlier retirement makes sense—either for the individual or for society—when one considers the probability of more older people living somewhat longer and with a high proportion of those in the younger part of the aged population being in reasonably good health. One quite possible and highly rational response to the change in the population distribution that will arise under the fertility assumptions leading to ZPG would be for society to employ a higher proportion of people over 60 rather than a lower proportion as has been assumed in the cost estimates.

The most fundamental determinant of the cost of pensions is the proportion of the aged group that is productively employed. This is true because private plans almost always require retirement from the particular employer or industry as a condition of drawing benefits, and social security reduces benefits in proportion to earnings for those who earn more than relatively low exempt amounts.

I believe if we want to continue retirement plans that replace wages to the extent we have promised, improve health insurance and long-term institutional care for the elderly, and add the services needed to allow older people to be cared for outside of institutions if they prefer, we had better give high priority over the next 30 years—before the crunch comes—to reversing the trend toward earlier and earlier retirement. It is one thing to be able to support good retirement programs and other programs for the elderly under conditions of a rapidly increasing population over 65 if most people work up to 65 or later. It is something else again if people generally stop working at 60 or even younger.

It should be pointed out, on the other hand, that the increasing demand on goods and services by the aged, which would result from these population projections, will be offset by a decline in the number of younger dependents. If we look not just at the aged but at the combined number of people below 20 and over 65, and consider this combined group to be the number to be supported by active workers, we get a very different picture than when looking at the aged alone. Even allowing a higher per person living cost for older people than for children, it still can be said with considerable confidence that the kind of population shift that may occur in the next century does not represent any real increase in the overall economic burden on active workers, but rather an increased obligation to support older people, balanced by a lessening of the obligation to support children. Moreover, it may be assumed that with fewer children a higher proportion of women will work in the future as compared with today, a fact that improves the ratio of workers to retirees.

From the narrow point of view of the closed system of social security, however, there may well be a problem. Since about four-fifths of the cost of the system is for the payment of benefits to older people, the somewhat lower cost to the system for the survivors' and dependents' benefits paid to children is offsetting to only a minor degree, and increases in labor force participation by women has already been taken into account by the trustees. Looked at strictly from the standpoint of the social security system in the next century, the issue could well become whether the "savings" from the lessened burden of dependent children can be translated into a willingness to pay higher rates for retirement protection.

CONCLUSION

Now what does this all add up to? I believe the wise policy would be to take action now that would fully support the system into the next century by gradually increasing the maximum amount of earnings counted for benefits and contributions and by moving up the contribution rate increase now scheduled for 2011. I believe also that the automatic provisions should be changed to stabilize the replacement rate. These actions would reduce the estimated long-range imbalance as shown in Appendix B of the recently issued Trustees' Report to less than 3% of payroll.

To help further reduce this estimated imbalance I believe we should work toward policies that promote, rather than reduce, employment opportunities for older people.

Whether after these actions an imbalance would still develop in the next century is uncertain. We will know much more about that 10 or 15 years from now after we have had a chance to observe the developing trend of fertility rates and the other uncertain factors that govern long-range costs. In any event, because of the possibility of some remaining long term deficit I believe it would serve to underline the government's determination to meet all future social security obligations as they fall due to put back into the Social Security Act a provision about general revenues financing that was in the law from 1944 to 1950 as follows: "There is also authorized to be appropriated to the trust fund such additional sums as may be required to finance the benefits and payments provided in this title."

Chairman HUMPHREY. Mr. Cruikshank.

STATEMENT OF NELSON H. CRUIKSHANK, PRESIDENT, NATIONAL COUNCIL OF SENIOR CITIZENS

MR. CRUIKSHANK. Mr. Chairman, and members of the committee and colleagues on the panel, I shall try to be brief in deference to Miss Miller and your time, too.

I have a prepared statement which I have submitted, Mr. Chairman.

Chairman HUMPHREY. It will be placed in the record, the full text.

MR. CRUIKSHANK. Thank you very much.

We are all glad that your committee, the Joint Economic Committee, is taking a timely review of the needs of the social security system

in connection also with its accomplishments. Several members this morning earlier mentioned the references to the press and the attacks on the system. And some of these have some validity, but many of them are scare stories that are not based on actual facts, but the accomplishments don't always get the same coverage. Thirty-two million and more people are now drawing monthly benefits. Of which I am one. These benefits are often taken for granted.

People are working now that were not born when the social security system was passed, and the benefits to their parents, to some of their dependents and others, are considered as something that is just a part of the world as it is, and they don't take into account what the system and what our society would be without them.

In the earlier testimony, in Mr. Cardwell's statement, and Mr. Ball's statement, reference has been made to the design and financial needs of the system. And it is quite proper we divide them into the two basic areas of the short-term problems as contrasted to the long-term problems as they are different in kind as well as in degree.

However, I would add this note at this point, that while it is true that the long-term estimates are based on assumptions that are increasingly difficult, as you get down in the years, to properly evaluate, that this is to some extent true also of the short-term estimates.

For example, the trustees report estimates that this year will be a deficit in the cash benefit payment funds of \$4.3 billion. And just last year they estimated it would be \$5.8 billion.

Now, that is a substantial difference. And it is a result of the fact that last year they didn't anticipate the effect of even the modest degree of recovery which we have experienced so far.

So that while we need to have these actuarial estimates, and we need to have the best judgment we can about both the near future and the participant's future, we have to recognize that we can't take them always as being absolutely valid.

When we look at that substantial difference in one short year in the withdrawals, the excessive withdrawals over income of \$1.5 billion, it raises a question in my mind, if we would move rapidly toward full employment—if, for example, the Humphrey-Hawkins bill were passed and we would set a goal of 3 years in reducing unemployment to the goals that that bill has, we would find that the next year's trustees' report would be making probably still more optimistic forecasts.

Now, one of the things that is significant to me as I view this situation today is that apparently everyone agrees that the necessary correction should be made. Before the Ways and Means Committee of the House, the Subcommittee on Social Security, the business community came in and testified as to the necessity of making corrections.

The President has made proposals, not all of them yet reduced to legislative proposals, but the President's message has made proposals. The senior citizens organizations have recommended changes in the system. The labor movement has supported changes. Everyone as far as I know recognizes the need to meet the contingencies of this system and its financial requirements.

There are differences of course in the methods. We differ with the method proposed by the President to meet the short-term shortfall. He wants an increase in the tax rate. We want an increase in the tax

base. And as Mr. Ball has pointed out, the amount of the total wages taxed by the system now is considerably short of what it was when the system was first inaugurated in 1935, and when we first collected taxes in 1937. We believe we should move gradually up to that point.

Everybody is apparently agreed that the decoupling measure should be adopted. And we were so insistent on this, and believed so firmly that the passage of the decoupling measure would restore public confidence to a large degree, that we worked with Senator Bentsen in getting a bill, S. 2901, before the Senate which embodies the recommendations of the Advisory Council of last year. And that bill is now before the Senate. And we would hope that they could find the means to adopt it shortly.

I would like to point this out too, that if these assumptions in the long run are correct or even partially correct, that is, the demographic changes, and all that are forecast, they apply not only to the social security system, but to all of our other arrangements for meeting the problems of the elderly or those who can no longer produce because of age or disability or because of death of the family breadwinner.

Our private pension plans are in just as much trouble as our public pension plans or our public retirement plans if those forecasts are even partially true.

In other words, it is a problem of our society. Some of the press reports and some of the scare stories in the press would lead one to believe that our problem is the social security system. Our problem arises from these demographic shifts and in the nature of the operation of our economy. The social security system is not the problem, the social security system is the answer.

Now, in some respects it is an inadequate answer. In some respects it contains certain inequities, but it is the best answer we are able to work out so far. And it has worked well up to the present time, and we have confidence that it is going to work well into the future.

One final point I would like to make, and that is, without attempting at all to instruct you distinguished members in the essence of the system, I think it is important that the American public should understand that our social security system as well as our private pension plans are only the fiscal arrangements by means of which we transfer the products of our economy to those who are in need for one cause or another.

Now, when I was still working and on the payroll, and I made contributions to the social security system, what I was doing was saying, I will buy so many less pairs of shoes or so many less suits of clothes or less consumer items in this payroll year, in return for which I expect that other people will withdraw some purchasing power from the system in the future, and allow me to continue to have some purchasing power to meet my wants.

Now, the social security system is the only income maintenance system that has in it the ability to transfer these real wages into real benefits. So, that if while working I withdraw purchasing power for x amount of consumer items, I can have equal x amount of consumer items when it comes time for me to retire as I have, or when it comes time for other workers to retire who are now working.

Private pension systems can't do that except to a very limited degree. But we have in the public social security system the mechanisms for translating the real wages into real benefits. And of course we do this by the cost of living increases automatically.

In other words, these fiscal arrangements are just the mechanism by which we meet the problems of the nonproducers in our economy. And I mean of course primarily the nonvoluntary, nonproducers who, because of old age or disability, or some other contingency, are no longer able to make their direct contribution into the system.

So, if we can point out that this social security system is an integral part of our whole economic system, gentlemen, it will be clear that we can't have a healthy social security system in an unhealthy economy. But if we can get the system moving; if we move toward full employment, and meaningfully toward those goals, the problem of the fiscal arrangements and machinery by which we meet the needs of those who can no longer produce because of old age, disability, or who are in need because of the death of the family producer, then these problems will fall into place and become readily manageable, and I believe that the Congress will manage it.

Thank you very much.

[The prepared statement of Mr. Cruikshank follows:]

PREPARED STATEMENT OF NELSON H. CRUIKSHANK

Mr. Chairman, Members of the Joint Economic Committee, my name is Nelson H. Cruikshank. I am President of the National Council of Senior Citizens.

The National Council is a nonprofit, nonpartisan organization of more than 3,500 older people's clubs across the country, representing over three million members.

I deeply appreciate the opportunity to comment on the current status of the social security trust fund and the outlook for the future.

The well-being and peace of mind of past and current generations of workers of all ages and their families has been enhanced by the existence of the social security program. Unjustified concern over the financial stability of the program and its continuing contribution to the well-being of future generations results from a lack of understanding of the nature and causes of the financing difficulties, and I might add, a lack of initiative on the part of the Administration to generate a healthier economic climate in a timely fashion or of sufficient proportions.

The nature of the financing difficulties is properly separated into two distinct aspects: first, as the Committee is aware, there is a short-run problem of temporary deficits in revenues relative to the level of benefit payouts that are a direct result of the high unemployment and low growth rate of the economy coupled with unusually high rates of inflation in recent years; second, a long-run imbalance between revenues and cash benefits is forecast, in part due to a projected rise in the proportion of aged and retired persons in the population, but largely due to an unintended, but easily correctable, error in the 1972 amendments which, under some circumstances, may overcompensate future retirees for the effects of inflation.

Clearly, the underlying causes of the current and projected financial difficulties are economic, demographic, and technical in nature—salted and peppered with a large amount of speculation. It is important to understand that none reflects on the inherent merit of the social insurance principle, or on the inherent soundness of the social security system. The problems of short-run deficits and a technical flaw in the automatic provisions are easily correctable. The problem of the speculated rise in the ratio of retirees to labor force participants—if it can be called a problem at all—is not unique to social security; it would confront any society which protected its elderly, its disabled, and its dependent survivors against economic insecurity. In addition, assuming the demographic projections are accurate reflections of the composition of the population 70 years

from now, it has been estimated that relatively modest changes in the tax rates (a maximum combined increase of approximately four percentage points) would be sufficient to maintain present replacement rates. (This assumes that the defect in the automatic provisions is remedied, i.e., "decoupling.") Other options, also of less than alarming proportions, and in our view preferable to reliance on tax rate increases alone, are also possible. It is far too early, however, to make these decisions. But the evidence is sufficient to indicate that the dire predictions of alarmists are not well grounded in fact.

Recognition of the causes of the financial problems of the social security system presents strong arguments—not for the weakness of the system, but for the strength of the system.

First, it acts as an offset to recession by generating those same deficits for which it is criticized. This effect is, of course, wholly consistent with program objectives of replacing a portion of earnings for those whose labor force attachment ceases by reason of age, disability, or death. Recession contributes to involuntary retirement and the social security program acts both to reduce economic insecurity and to invigorate the economy. In this context, an important point deserves explicit mention. There is nothing intolerable about the notion of a short-run deficit; this by itself does not bring into question the actuarial soundness of the system. Rather, the current concern is over the size and duration of the shortfall relative to the size of the Trust Fund which is intended to serve as a contingency for just such occurrences. The predicted exhaustion of OASDI Trust Funds shortly after 1980 is therefore justifiably of concern, but the inevitable fact that the system will have temporary deficits as well as temporary surpluses is not of concern. But inept management of the economy and an unprecedented tolerance for persistently high unemployment are the underlying problem, not the social security system.

Second, rather than suggesting that the system will be subjected to alarming difficulties in the 21st century, the growth in size of the older population suggests that the social security system is destined to play an even greater role in the future than it has in the past.

It is therefore of crucial importance that any changes to the system be carefully devised with full knowledge and understanding of the intent and functioning of the program.

THE SHORT RUN DIFFICULTY

The short run imbalance between revenues and outgo has caused a proliferation of suggested remedies, from immediate rises in the tax rate or the taxable wage base, the introduction of general revenues as a partial revenue base, to—in one case—a one time infusion of general revenues from the treasury in the amount of \$5 billion. Although any of these measures would serve to offset the recent adverse experience of the trust funds, there are significant differences. There is no difference of opinion among segments of society that social security financing should be strengthened; the President has made a proposal, business interests, organized labor, economists, as well as the National Council of Senior Citizens—all have offered proposals. The major difference lies in the means by which the system should be strengthened.

The President had proposed a tax rate increase of 0.6 per cent, half to be borne by employees and half by employers. As the Committee is aware, the system will require approximately ten per cent additional revenues over the next 25 years; the President's proposal addressed the needs of the ensuing ten years.

There are, in any case, alternative means to generate revenues which the National Council finds preferable—more specifically, raising the taxable wage base. It has been estimated that comparable revenues could be raised by increasing the maximum earnings base from the \$16,500 figure it is expected to be in 1977, (it is \$15,300 for 1976 but is automatically adjusted upward as wages rise) to \$21,300 in 1977. Although both expansion of the wage base and the President's proposal would provide an excess of income relative to benefit payouts until about 1985, there are important differences which must be carefully considered.

First, an increase in the earnings base is desirable in its own right. In the early years of the program, over 95 per cent of all the workers in the program had all their wages covered; today, only 85 per cent of workers have their full wages counted towards social security benefits. Raising the maximum to \$21,300 would move in the direction of restoring the original purpose of including the full wages of all but the most highly paid workers.

Additionally, under an increase in the taxable base, those who pay more receive more protection in return, while under a rate increase everyone pays more and no one gets more benefits. (Although the latter is clearly less than equitable, I suspect this is exactly why the Administration favored the tax rate increase.)

Moreover, an increase in the earnings base makes program financing more progressive while reducing the long-run cost of the program. (This assumes the error in the automatic provisions is corrected.) This is true because contributions from higher earnings accrue at a proportional rate, while the replacement rate used in calculating benefits is applied at a declining rate as income rises.

In regard to what would happen to the distribution of income, there is no speculation involved in saying that the lower earnings worker would be more heavily penalized by a tax rate increase than by raising the taxable base. In the latter case, earnings below \$15,300 would not be affected; those with greater ability-to-pay through higher earnings would shoulder the increase, offset, at least in part, by greater benefits after retirement. With a tax rate increase there are only losers, not gainers.

One of the other options to either a rise in payroll taxes or to raising the taxable wage base, is, of course, a contribution from general revenues.

The National Council has in the past indicated its support of tri-partite financing. The long-range goal of the National Council of Senior Citizens is a strong social security system, covering both cash benefits and health insurance, financed partly through contributions of workers and their employers—thus preserving the important contributory principle of benefits as an earned right—and partly by contributions from the government in recognition of society's stake in a well-functioning social insurance program. However, because it appears that general revenue financing may not be (politically) feasible at this time, we prefer to retain this option for a time when it could serve as a resource to enable improvements to be made in real benefits in the more comprehensive program.

We are therefore in support of remedial action in the short run (the next ten years) which adheres to the customary manner of financing. However, the National Council favors raising the taxable wage base and vehemently opposes raising tax rates for all the reasons previously indicated.

We do recognize, however, that all approaches which require that additional revenues be raised—whether from tax rate increases, increases in the taxable wage base, or from additional general revenues—would remove a certain amount of stimulus from the economy. This is considered by many to be currently undesirable. The question then becomes one of timing. How important is it that the short-run imbalance be remedied immediately?

On the one hand, the actuarial soundness of the system does not depend on short-run deviations from the average. It is acceptable to have a temporary imbalance which is not intrinsic to the system itself, with the contingency met by drawing down the reserve funds. This is, in fact, the major purpose of the trust funds.

On the other hand, public concerns over the soundness of the system are aggravated by such occurrences, and are detrimental to people's confidence in their government and their future security. This difficulty is increased by long-run projections which compound the effect of short-run difficulties into the future when no counteracting provisions are incorporated into the estimates.

Therefore, it seems advisable to take immediate action—preferably by raising the taxable wage base—but deferring the effective date of such a change beyond fiscal 1977. In this way, both the concerns of the American public and the need for current fiscal stimulus could be achieved by the simple device of an "announcement effect."

Additionally, an extremely important course of action that is both in the national interest and in the interest of remedying the short-run and long-run problems of the social security system is vigorous movement towards full employment. I not doubt that the unexplained, extremely adverse experience of the disability trust fund, in particular, is in large part a consequence of unusually high levels of unemployment. Prolonged unemployment has been documented as a cause of illness, and furthermore, the perception of disability—even medically—may well be flavored by poor labor market potential. A national goal of full employment may serve to alleviate the ills of the social security system and the ills of society.

THE LONG RUN DIFFICULTY: OVER INDEXING

The 1972 Amendments to the Social Security Act introduced a mechanism for automatic adjustment to changes in the cost of living. Unfortunately, an unintended error allows future retirees to be overcompensated under certain wage and price patterns. For example, under current law, primary insurance amounts (PIA's) are calculated as a per cent of a worker's average monthly earnings (AMW's) in covered employment at eight discrete threshold levels: approximately 129 per cent of the first \$110 of AMW, 47 per cent of the next \$290 of AMW, 44 per cent of the next \$150 of AMW—down to a low of 20 per cent of the last \$100 of AMW of covered wages. The adjustment takes place by adding to each conversion factor the per cent increase in prices which is then used to determine the benefit level. Thus, if the rate of price increases is 6.4 per cent, the new benefit level will be calculated as 135.4 ($129 + 6.4$) per cent of the first \$110 of AMW, 53.4 ($47 + 6.4$) per cent of the next \$290 of AMW, and so forth. For those currently retired, this formula maintains real purchasing power; for future retirees whose AMW will already reflect wage increases to compensate for inflation during their working life, the add-on to the conversion factors will provide an over adjustment. Similarly, under circumstances of little or no inflation and rising real wages, replacement rates would decline due to the progressivity of the benefit formula. Thus, just as replacement rates may rise if price increases dominate wage increases, replacement rates could decline over time if wage increases dominate price increases. Clearly, replacement rates should be a function of deliberate policy and not an accident of outside forces.

The long-term projections based on assumptions which reflect the more rapid increase in prices relative to wages of recent years, indicate an estimated shortfall which amounts to approximately 50 per cent of the projected actuarial deficit over the ensuing 75 years. Thus, roughly 50 per cent of estimated long-term program costs could be eliminated by correcting the unintended error in cost-of-living adjustments. This should be done immediately.

However, decoupling the system requires that an explicit policy decision be made regarding the long-term level of replacement rates. If retirees are to maintain not only the purchasing power of their benefits, but also share in rising productivity over time and thus maintain their relative position in the income distribution, then the adjustment should be made on the basis of increases in wage rates. If the system were to be indexed solely on the basis of price increases, the replacement rate would decline because of the progressive nature of the benefit structure and even under conditions of constant purchasing power, retirees would be relatively worse-off than they are today. Since a person's well-being is intimately connected with his economic status relative to others, the National Council strongly favors the wage indexing approach as represented in the Bentsen bill (S. 2901). We urge that this approach be supported.

DEMOGRAPHIC CHANGES

Half of the projected deficit in the social security system is attributable to the anticipated change in the composition of the population early in the 21st century. The expected changes indicate a greater proportion of individuals 65 years and over relative to the working age population. Under such circumstances, the ratio of contributors to beneficiaries would be smaller than is currently the case, and the burden on the working generation would be larger than many feel is tolerable, given the current method of internal pay-as-you-go financing. There are a number of feasible solutions that would neither jeopardize future benefits nor inflict intolerable burdens on the working population, but among the simplest is redressing the imbalance between contributors and beneficiaries by encouraging greater labor force participation among all age groups, particularly those past social security retirement age. The retirement test ("earnings test") would delay receipt of social security benefits to those who earned above the prescribed amount, with concurrently greater levels of contributions flowing into the system.

One approach would be to redefine the retirement age in the context of the social security program, raising it to perhaps 67 or 68 years of age. Consistent with the function of the program to replace earnings lost due to retirement, death or disability and with future financing needs, the social security program must therefore retain the retirement test and not be turned into an annuity program.

This movement away from early retirement would be in line with the better

health and greater longevity of senior citizens. However, it would be a futile exercise and contrary to the intent of the program if a necessary condition were absent; that is, full employment conditions. However, even under full employment conditions, retirement at the present statutory retirement age should be a matter of individual choice.

But how certain are the conditions which indicate these future difficulties? It is important to note that estimating fertility rates and, hence, population, many years into the future is a tenuous business at best. Although the direction of change in fertility rates since 1957 has progressed steadily downward from 3.77 to the recent low of 1.9 and is expected to stabilize in coming years around 2.1, or zero population growth, the history prior to 1957 including the past 75 years indicates a fluctuating pattern.

It was high at the turn of the century, dropped sharply during the depression years of the 30's, began to rise significantly during World War II, on through 1957. I would speculate that fertility rates are a function of the complicated interaction of changing socio-cultural institutions, economic climate, expectations for the future and unanticipated events. In that the projected difficulties of the social security system are extremely sensitive to fertility rates and labor force participation rates, even a slight movement away from current lows would lessen the seriousness of projected financing difficulties.

Additionally, just as the older age group is expected to become an increasing proportion of the population, so the proportion of the younger dependent population is expected to decline. Although it is not clear whether or not this would be offsetting on balance, it is possible that some net resources might be freed for transfer to the older generation without any increase in the overall burden.

In any case, the difficulties associated with the changing composition of the population are of manageable proportions.

WITHDRAWALS FROM THE SOCIAL SECURITY SYSTEM

Attention has recently been drawn to the announced intention of withdrawal from the system of the City of New York, among other jurisdictions. This event has been treated as if it represents a stampede away from a "bad buy." Both the magnitude of this effect in recent years has been exaggerated and the charge that social security is a "bad buy" is far from the truth. However, it has made quite visible the fact that not all workers are covered under social security and that some groups are only voluntarily covered with the option of withdrawal when certain conditions are met.

Historically, public employees at the sub-national level were given voluntary privileges to avoid a constitutional confrontation on the issue of the power of the federal government to interfere with the functioning of state and local government through taxation. Other groups such as nonprofit organizations were given similar privileges to avoid jeopardizing tax exempt status.

The number of withdrawals before this year account for approximately 45,000 employees, primarily from small jurisdictions. Applications for withdrawal accounting for 53,000 employees have been made, but several may not complete the process. Based on current requests, the next two years could bring withdrawals by 232 jurisdictions, representing 454,000 workers. New York City represents the largest proportion with withdrawal notice, effective March 1978, which covers 362,000 employees.

In that a significant proportion of withdrawal announcements have occurred within the last four years, they would appear to be recession induced. Therefore, this problem, too, appears to be rooted in a lack of full employment as is the short-run imbalance in the trust funds. The withdrawals, however, would also have a longer run adverse effect—both on employees who are no longer in the system or who are not privileged to enter, and on the system itself. The system will retain the liability towards those who have accumulated sufficient quarters of coverage, while contributions from those individuals and their employer will have ceased. In the case of New York, this unfunded liability has been estimated to exceed \$3 billion.

The obvious solution to this recent adverse trend is to extend mandatory coverage across all workers, including Federal civilian employment. Ideally, the social security program should provide basic retirement income with the Government plans—both Federal, State and local—supplementary staff plans, similar to the pension plans in private industry. It is significant to note that the two labor unions having the largest membership in State and local government em-

ployment are on record in support of this principle and vigorously oppose withdrawal from social security coverage. The reasons which justify this course of action transcend cost considerations, although this is certainly an important aspect.

The social security system represents a balance between two goals: (1) individual equity, and (2) social adequacy. Contributions into the system support three elements consistent with the overall goals:

1. future security for self and spouse when retirement is likely to occur;
2. future security for self, spouse, and other dependents should the unfortunate event of disability or premature death of the family breadwinner occurs; and
3. adequate security for less fortunate members of society who have low earnings histories, irregular employment, or become disabled or who die leaving dependents.

There appears to be no justifiable reason why anyone should be excused from supporting the third element. Additionally, Reinhard A. Hohaus, in his classic statement in 1938 said:¹

"Directed against a dependency problem, social insurance is generally compulsory—not voluntary—giving the individual for whom it is intended no choice as to membership. Nor can he as a rule select the kind and amount of protection or the price to be paid for it. All this is specified in the plan, and little, if any, latitude is left for individual treatment. Indeed, social insurance views society as a whole and deals with the individual only in so far as he constitutes one small element of that whole. Consistent with this philosophy, its first objective in the matter of benefits should, therefore, be that those covered by it will, so far as possible, be assured of that minimum income which in most cases will prevent their becoming a charge of society. Not until this is accomplished should financial resources (whatever, if anything, may remain of them) be considered as available to provide individual differentiation aiming at equity."

The constitutional issues in this approach have never been challenged; there is legitimate reason to do so at this point in time. As a lay observer of the constitutional questions, it appears to me that the constraint on inter-jurisdictional migration and employment imposed by lack of universal social security coverage is at least an equal if not a greater violation of constitutional rights of individuals than the issue upon which current practice is based. We therefore urge that consideration be given to gradual inclusion of all workers in the social security system, with significant time allowed for coordination of social security benefits with existing pension plans.

I would like to add that the claims that social security is a "bad buy" are spurious. First, social insurance is not directly comparable to private insurance, either in terms of its goals or in terms of its financing mechanisms. Second, the soundness of a social insurance program rests on its public acceptance and the continuing taxing authority of government. Therefore, statements indicating that social security is a poor value or that the system is on the verge of bankruptcy represent uninformed judgment and a perception of the system which is incorrect. That the system must respond to the changing needs of a dynamic society is without doubt; that it can make these adjustments is also without doubt. Private insurance cannot make these same claims. This is the essential ingredient of strength and value in the social security system.

SUPPLEMENTAL SECURITY INCOME

The means-tested SSI program was designed as a complement to the social security program for lower income aged, blind and disabled. A primary motivation was the need to take the pressure off raising benefit minimums in the social security program. It was felt that social adequacy achieved through redistributive elements in the social security system and supported by current workers had been carried as far as it could be, but that the goal of social adequacy itself had not been carried far enough. Therefore, SSI is intended to further the adequate maintenance of those among the least fortunate in society, with the burden shared based on principles of ability-to-pay through general revenues from income taxes. Those covered under SSI represent individuals either not covered under social security or with only minimal coverage. The income offset in SSI

¹ "Equity, Adequacy, and Related Factors in Old Age Security," *The Record*, American Institute of Actuaries, Vol. 37 (1938).

includes a dollar for dollar reduction in SSI benefits for receipt of social security benefits. Thus, the two programs operate in tandem with SSI substituting for the provision of more adequate minimum benefits in the social security program. At present, the benefit levels in SSI are too low to be considered as having met goals of social adequacy. Present benefit levels, in the absence of other income, are \$157.70 per month for an individual and \$236.60 per month for a couple—amounts which are below the poverty level threshold. Thus, improvements in benefit levels in SSI are urgently required.

CONCLUSIONS

In summary, while there are some difficulties to be faced regarding the social security program, it nevertheless ranks as the most successful social program ever initiated in this country.

The short run financing imbalance is a result of recession and inflation; the longer run projection over the next 75 years is adversely affected by unintended over-indexing of benefits which is an easily corrected error, but the real problem presented to the system—if it can be called a problem at all—is the expected change in the proportion of the aged in the population. Social security, however, is not the problem—it is the answer!

The system may be incomplete in many respects and the period of transition to adjust to the changing needs of society may present momentary difficulties, but the social security system is the best that our society has yet devised. Those who would scuttle or drastically alter the system in the name of the worker should cause us to be wary of their motives. There is an old saying of organized labor: "When the boss gets concerned about the welfare of the worker, beware!"

Therefore, no hasty, ill-considered actions should be taken at this time.

Chairman HUMPHREY. Thank you very much, Mr. Cruikshank.
Miss Miller, we welcome your testimony.

STATEMENT OF HARRIET MILLER, EXECUTIVE DIRECTOR, NATIONAL RETIRED TEACHERS ASSOCIATION AND AMERICAN ASSOCIATION OF RETIRED PERSONS

Miss MILLER. Thank you, Mr. Chairman.

I appreciate the opportunity to appear here today, and I want to commend you for your interest in the subject of social security.

I am Harriet Miller, executive director of the National Retired Teachers Association and the American Association of Retired Persons. On behalf of the 9.5 million members of our two associations, I would like to thank the members of the committee for the opportunity to appear here today and further, to commend you for your interest in the subject of social security. We hope this interest will continue.

Our members' interests are vitally affected by what happens in the social security area. The release of the social security trustees report on Monday and the irresponsible manner in which information from that report has been handled by some members of the media only serves to underscore the need for these hearings. The social security system is not bankrupt, insolvent or "busted." Nor is it in any real danger of being so and this fact must be made crystal clear to the American people.

The trustees report has pointed out that because of recent economic conditions, the system will run a deficit at least through 1981. This, in turn, will cause the trust fund to be reduced. What must be understood, however, is that this is exactly why the trust fund was created—to finance deficits.

Social security benefits depend not upon the trust fund, but rather, upon income from the payroll tax and ultimately, on the taxation power of the Federal Government. It is difficult to understand how the OASDI system with a 1976 annual income in excess of \$73 billion a year and with a projected reserve of more than \$40 billion in assets by the end of 1976 can be termed insolvent.

In our view, current economic developments indicate that the actuarial estimates made under the optimistic assumptions in the trustees report, are those most likely to become fact and, if so, the fund at the end of 1981 will be sufficient to finance something of the order of 10 more years of deficits if necessary.

In summary, for the short range, although the social security system will run a deficit for the next few years, we have a problem, not a crisis.

With respect to the long-range problems of the system, we agree that current benefits for retirees immediately should be separated from future benefits for today's workers—that the system be decoupled. We would add that once this is completed, significant financing problems arising from projected demographic changes are not expected to occur until after the turn of the century—25 years from now. There is plenty of time between now and then to carefully and deliberately consider our future problems and act to solve them.

The social security system does require change. There are serious equity questions to be faced. For example, the treatment of women under social security, and the job of more fully integrating the social security system with SSI. When the economy has become stronger, some means must be found to bring additional revenue into the system if benefit levels are to be improved and these needed changes undertaken.

What the social security system needs most from the administration as well, are strong statements of support based upon the facts. Those facts indicate that the social security system is far from being bankrupt. The Congress must take those necessary legislative steps to restore public confidence in a strong and viable institution that will continue to provide the income support in retirement that has so benefited older members of our society to date.

This concludes my introductory remarks and I will be happy to attempt to answer any questions you might have.

[The prepared statement of Miss Miller follows:]

PREPARED STATEMENT OF HARRIET MILLER

I. THE 1976 OASDI TRUSTEES REPORT: THE FINANCING PROBLEMS

On May 24th, the 1976 OASDI Trustees Report was released. On the basis of certain economic assumptions, the Report projects an annual excess of benefit payouts over contribution revenue, at least through 1981. Should these assumptions hold true and the deficits materialize, the Trust Funds (in the absence of Congressional action) will eventually be exhausted.

With respect to long-run financing problems, the Report reiterates the need, first identified last year by the Advisory Council and the Trustees, to decouple the indexing of benefits after retirement, death of spouse or disability in accordance with CPI from the indexing of current workers' earnings/contribution records in the computation of their future initial benefit awards. Once the system is decoupled, significant long-term financial problems for the system as a result of demographic changes are not expected to occur until after the turn of the century—twenty-five years from now.

Despite the 'Trustees' projections, and contrary to representations made by some members of the press and the critics of social security, the system is in no way bankrupt, insolvent or "broke;" nor is it in any immediate danger of becoming so. The annual deficits projected in the Report are based on economic assumptions that may or may not hold true. But even if they do, and the Trust Funds decline, that is exactly what the Trust Funds are for—to provide for an excess of payouts over revenue during hard times. Benefit depends not upon the Trust Funds but upon revenue from the payroll and self-employment taxes and, ultimately, on the taxing power of the Federal Government. Obviously, a system that directly affects 160 million workers and 32 million beneficiaries will not be allowed to become insolvent.

II. THE NEED FOR IMMEDIATE ACTION TO STRENGTHEN THE SYSTEM'S SHORT TERM FINANCING

It is clear that the shorter financial imbalance does not require immediate legislative action to increase program income. Indeed, because the imbalance could cure itself (before exhaustion of the Trust Funds) if contribution revenue swings back into favorable balance with benefit outlay under the influence of a rapid and sustained economic recovery, it may turn out that no legislative action is needed at all.

Of course, the appropriateness of Congressional inaction assumes that: (1) the rates of inflation and unemployment will continue to decline; and (2) the economy will continue an uninterrupted and optimum rate of recovery. Obviously, such a combination of assumptions involves a certain degree of risk. Economic trends could change. However, the risk involved in relying on a continuation of these trends, while certainly a factor that must be taken into account in deciding if and when to act, should not be the primary stimulus to Congressional action. Action could always be taken later if the economic trends do not, in fact, continue.

There are, however, major non-economic reasons why the Congress should act and act as soon as possible. First, it would reinforce confidence in the financial security and integrity of the system. Second, it would help stem the developing trend toward termination of social security public employee group coverage. Finally, it would clear the way for consideration of the type of comprehensive reform legislation that will enable the system to accommodate better the needs of the people it serves. For our Associations, these three reasons are persuasive of the need for Congressional action in the near term.

Since inflation and unemployment will continue to have a significant impact on the OASDI programs' financial soundness, the Congress, in selecting appropriate remedies to increase program income, must view the system in the context of the economy in which it exists. In comparing the relative merits of the various remedies (or combinations thereof) available, the Congress must weigh the probable economic consequences of those remedies over the period 1976 to 1981 and not be diverted from doing so by arguments that the system has historically been "self-financed" and "contributory" and that remedies which do not conform with traditional principles should not, therefore, be considered. The causes of the short-term financial imbalance are not internal to the system, but rather are external. Since the causes are external, the Congress should not, in making a choice, limit the class of potential choices merely to those that are internal—namely, payroll, self-employment tax rate and/or contribution benefit base increases.

III. NRTA-AARP PROPOSAL TO DEAL WITH THE SHORT-TERM FINANCIAL IMBALANCE

A. In general

To deal with the short-term financial imbalance, our Associations propose to defray the "net" benefit cost of automatic benefit increases to the extent that they exceed 3 percent per year out of general revenues.

Second, if more revenue, in addition to the annual general revenue contributions, is needed, such revenue should be generated through a legislated increase in the contribution/benefit base effective in 1977.

B. Description of the proposal for limited and temporary general revenue contributions and the manner in which the size of those contributions would be determined from year to year

Under present law, OASDI benefit levels increase automatically in accordance with percentage increases in the CPI. The contribution/benefit base increases

automatically in accordance with the rate of increase in average wages in social security covered employment. The base increases are triggered by the automatic benefit increases.

Because the size of the contribution/benefit base increases under Section 230 of the Social Security Act is not related to the size of the benefit increases under Section 215(i) and because the timing of the former, though triggered by Section 215(i) increases, differs from the timing of the latter, the manner of crediting a part of the Section 230 revenue from the base increases against the new government contributions from general revenues must be determined.

Our Associations propose that the aggregate cost for each fiscal year of the "above-3-percent" part of all automatic benefit increases effected in that and prior fiscal years be determined, and that there be set off against that cost, the yield for that year, from all Section 230 increases effected in that and prior fiscal years after deducting the cost (for that year) of the 3 percent part of all Section 215(i) increases.

C. Rationale

In considering the merits of our Associations' proposal, it must be remembered that the short-term financial imbalance is the result of what has happened (and what is reasonably expected to happen) with respect to inflation and unemployment over the near term. Therefore, any remedy (or combination thereof) adopted should also be evaluated on the basis of its (their) impact(s) upon the economy.

While the rate of inflation (as measured by the CPI) has been reduced from nearly 12 percent in 1974 to 7 percent in 1975, the policies pursued by the federal government to achieve that reduction precipitated an intense recession that generated the highest rate of unemployment since the 1930's. It is desirable, therefore, in choosing remedies, to avoid those which would impede an optimum rate of economic recovery (and which would prolong the unemployment problem) or tend to increase inflationary pressures within the general economy later. On these grounds, the Administration's proposed payroll tax rate increase, which, if enacted, would be permanent, appears inappropriate.

In the near-term, the adoption of such a rate increase would be a major shift toward a more restrictive fiscal policy at a time (fiscal year 1977) when a less restrictive policy still appears to be needed to sustain the economic recovery and reduce unemployment. The immediate impact of the tax increase would, of course, be deflationary, but its dampening effect on the inflation rate may be clearly outweighed by the attendant unemployment and lost output costs.

Over the long-term, as the economy recovers, workers should be expected to try to make up, in wage and salary increases, for the aggregate purchasing power they lost because of inflation in the 1973-75 period. A payroll tax increase would only add to these expected wage and salary demands. Such wage demands and the employer's increased tax burden would increase production costs. While employers may not be able to shift the burden of such increased costs forward onto consumers in the form of higher prices immediately (except, perhaps in the case of employers in the concentrated industrial sectors where market power is strong), the Administration's proposal could increase inflationary pressures within the general economy later when the economy begins to approach full employment and full production and consumer demand is strong. Employers should then find it much easier to shift forward those increased production costs.

Another means of generating additional revenue for the system would be through a major increase in the contribution/benefit base over and above the level it would otherwise reach under the automatic provisions of present law. Although an increase in the base would make the payroll tax structure less regressive and, at the same time, would increase benefits to be received in the future by those who would be affected by the higher base, our Associations do not believe that this method should be relied upon as the primary means of dealing with the short-term problem.

First, a very substantial legislated increase in the contribution/benefit base could cause social security to interfere with private savings and capital formation. Second, the increased amounts that would have to be contributed by employers on the higher base would likely have adverse impacts upon the growth and expansion of the system of private employee pension benefit plans. Third,

the payroll/self-employment tax structure's potential to finance needed substantive reforms in the system would have been diminished. Finally, the burden of the increased taxes would fall on a very narrow segment of the taxpaying population (a segment of the population for whom the prospects of somewhat higher benefit levels in the future would not be much consolation) even though the short-term imbalance is the result of broad economic factors.

Ultimately, of course, the best way to restore balance between benefit payouts and contribution revenue is the absorption of the unemployed back into productive labor where they would resume paying social security contributions. But, while economic policies designed to achieve this end are being pursued, limited contributions from general revenues should be made for the reasons previously cited. Because of the manner in which the amount of such contributions would be determined, they would be both limited and temporary. As the economic recovery continues and the economy tends toward full employment, the increasing number of persons who would return to active employment would be paying social security contributions and this would, in turn, increase the amount of Section 230 revenue to the system, thereby reducing, and ultimately eliminating automatically, the general revenue contribution in subsequent fiscal years.

IV. FUTURE REPLACEMENT RATIOS: THE NEED FOR STABILITY AND ADEQUACY

Because of the manner in which the social security system is presently cost-indexed, earnings replacement ratios (which are generally defined as a worker's monthly benefit expressed as a percentage of his monthly wage just before his retirement, death or disability) can move capriciously, up or down, depending upon the relative movements of wages and prices over the long term. Since the cost of the system would also fluctuate depending upon those same movements and since they cannot be forecast with accuracy, the Social Security Advisory Council concluded that the OASDI programs are over-indexed and that in the future, an individual's contributions/earnings record should be restated in terms of the wage levels prevailing the year before the year in which he retires, becomes disabled or dies.

Our Associations agree with these findings and with this recommendation. We also agree that benefit levels under a decoupled system should not exceed 100 percent of an individual's average monthly indexed earnings amount (AMIE).

We do not, however, agree with the Council and the Administration on one crucial point. Both have said that the benefit formula that is constructed for the decoupled system should provide replacement ratios equivalent to those presently prevailing. Except in the case of low-income individuals, we think that present ratios are inadequate. The amount of earnings replaced under the decoupled system should not, we believe, be less than 55 percent of an individual's AMIE if he is to have a reasonable opportunity to maintain during retirement his pre-retirement standard of living.

We would oppose any decoupling proposal under which current employees' earnings/contribution records would be adjusted only for the inflation which occurs over their working career. Such a decoupled system would, in reality, have the effect of lowering replacement ratios and, in effect, cutting benefits. This would simply exacerbate the very substantial problem that is facing future retirees—achieving an adequate level of retirement income.

Once a benefit award is made, it should, of course, be adjusted for subsequent increases in living costs. We would add, however, that since the CPI reflects the expenditure pattern and price experience of urban wage earners and clerical workers rather than the aged, its use as the indexing standard likely understates the benefit increases the elderly should receive. Our Associations continue to urge that a separate index for the elderly be constructed and used to adjust OASDI, SSI and other retirement benefits.

V. SOCIAL SECURITY COVERAGE, COVERAGE EXCLUSIONS, TERMINATIONS OF VOLUNTARY COVERAGE AND RELATED ISSUES

A. Terminations: Impacts on revenue and future benefit protection

Except for an actual termination of coverage by New York City, it would appear that the aggregate revenue effect on social security as a result of past and anticipated future terminations by public employee groups, has been and will be

relatively insignificant. But as Commissioner Cardwell warned on April 25th before the Social Security Subcommittee of Ways and Means:

If . . . 50 percent of all state and local employees had their coverage terminated as of June 1978, the total loss in contributions and interest income for the 5-year period would be \$37.2 billion.

Aside from the projected impact on the system that could result from wholesale withdrawals, existing coverage exclusions and voluntary coverage and termination options have significant policy implications. On the one hand, some public employee groups that have not elected or cannot elect social security coverage are able to obtain "fully insured" status through supplementary or seasonal employment and can expect to retire with a benefit heavily weighted in their favor in addition to their own staff retirement benefit. The financial burden of the weighted/windfall portion of their benefits falls on the remaining contributors to the system.

On the other hand, there are substantial incentives for public employee groups to come into social security and reserve the option to withdraw. Social security benefits are increasingly valuable and completely portable. By entering the system, benefit rights can be obtained quickly with the cost spread over all covered employment. After dropping most of these costs on the system, and after having participated long enough for most members of the covered group to acquire fully-insured status, the option to terminate can look attractive.

Since old age benefit rights of fully insured individuals are not affected by a termination, post-termination contribution amounts can be accumulated for the purpose of providing a supplementary wage-related benefit under a separate system that more than offsets the amount by which the social security benefits would be reduced because of the years of non-contribution following termination. Not only do these individuals derive a significant advantage from social security's weighted benefit formula, but they can also expect to obtain the advantage of subsequent liberalizations in the cash benefit (OASDI) and Hospital Insurance (HI) programs. The financial burden falls on everyone else in the system.

But termination has its risks. First, failure to continue contributions may result in a loss of disability protection and may impair currently insured status for certain survivor benefits, lump sum death payments, and chronic renal disease protection under the Hospital Insurance program.

Second, if, after termination, a separate public employee system is established which attempts to guarantee that benefits to be paid will never be less than the amount that would have been paid if social security coverage had been continued, the guarantee may not be kept with respect to those not fully insured at time of termination. Considering the degree to which social security and Medicare benefits have been liberalized and extended in the past, and especially in view of the automatic cost-of-living benefit increases under present law, the cost consequences may undermine any separate system guarantee.

Third, for those members who are not fully insured at the time of termination, and for new workers subsequently hired, withdrawal may mean that they may never be insured for retirement, survivor, disability and HI benefits. Once a jurisdiction opts out of the system, it cannot come back in. Moreover, as time passes, the number of quarters of coverage required for fully insured status will continue to increase to 40, thus making it increasingly difficult for young public employees to obtain benefit rights.

From the point of view of national policy, there is little that can be said in favor of withdrawal, and what can be said is clearly outweighed by the likely diminution in benefit and cost-of-living protection for current and future public employees affected by a decision to terminate. We believe action must be taken to strengthen the disincentives to withdraw and increase the incentives to enter the system.

B. Recommendations to discourage withdrawal and encourage participation

Our Associations have consistently favored the principle of universal social security coverage. But while the system's structure has evolved in such a way as to require mandatory coverage, the realities are that the system is not universal and some employee groups that are covered have the option to withdraw.

Conceivably, the law could be amended to eliminate the right to withdraw on the part of covered groups already participating. However, such a change could entail substantial legal problems and would not be fair.

Instead, we first suggest that the employees of participating covered groups be given the opportunity to vote in a referendum on withdrawal—even if such a referendum can not be made binding on participating jurisdiction and even if it has to be conducted by the federal government. Employees must be provided with the information necessary to make an informed judgment and be given the right to express themselves.

Second, with respect to public employee groups which may enter the system in the future, the terms of the coverage agreement should specify that the option to withdraw is subject to approval by a two-thirds vote.

Third, it would not be unreasonable to freeze benefits as of the time of withdrawal for those who elect to opt out.

Fourth, we believe that the introduction of some general revenue financing of the social security system would act as both an incentive to participate and a disincentive to withdraw. Had some general revenue contributions been used to eliminate the short-term financial imbalance this year, state and local jurisdictions with the option to withdraw would have been put on notice that the exercise of the option would ultimately mean that their employees could end up having a portion of their federal income tax payments used for social security purposes even though those employees might be barred from full, or perhaps any, benefit from those payments. To reinforce this signal, there should be put back into the law the authority that once existed for the future use of general revenues. We believe that, after the turn of the century, a substantial and permanent general revenue contribution (in addition to employer and employee payroll taxes) will be necessary to finance future benefits because of demographic trends—even if the system is decoupled.

Fifth, the establishment of a decoupled social security system to decouple the cost-indexing of benefits after retirement could reinforce disincentives to withdraw and increase the incentives to participate if the formula used to compute those future benefit awards is properly constructed. As stated hereinabove, the formula should replace not less than 55 percent of a worker's monthly AMIE and should be weighted less heavily than the present one in order to emphasize the "earnings replacement" function and deemphasize the "minimum-floor-of-protection" function. The Supplemental Security Income program should be augmented to assume more fully the latter function. We believe that the restructuring of the benefit formula to bring about greater correlation between benefits and contributions coupled with the introduction of limited amounts of general revenue now with the authority to bring in more in the future as they are needed to accommodate demographic trends, will completely undo the arithmetic of those who may determine that they are better off by leaving the system.

Finally, other proposals to reform the social security benefit structure to give greater recognition to the contributions of working wives and double-earner families and the Advisory Council's recommendation to phase in provisions to offset social security derivative benefits by the amount of primary retirement benefits received by future retirees from other systems would also act as a disincentive to remain outside of or leave the system.

The objective of these proposals would be to signal to workers who are outside the system now or who are within the system but have the right to withdraw, that they cannot afford to remain outside the system or to withdraw from it.

C. The question of mandating social security coverage for all workers, including Federal employees

Our Associations recognize that a strong case can be made for simply mandating social security coverage for all workers including federal employees. Financing the social adequacy aspects of the present social security system and those that would remain even under a restructured decoupled system should be a widely shared obligation.

Because of the number of separate systems and the social security coverage exclusions, many who have been able to split their employment end up receiving heavily weighted social security benefits that result in the receipt of a windfall that was really not intended for them.

However, the mandating of employee coverage for all workers entails substantial difficulties. First, there may still be constitutional impediments. Second, jurisdictions without social security have established separate systems designed without taking social security into account. Benefits and contributions are generally high; if social security were simply added as a supplement, benefits

and contributions would likely to excessive. Moreover, since some states have constitutional prohibitions against reductions in retirement benefits, those benefits could not readily be reduced.

To us, the only reasonable means of achieving universal coverage would be along the lines suggested by Robert Tilove in his book *Public Employee Pension Funds*—to mandate such coverage only for new employees hired three to five years after the enactment of the necessary legislation.

States and localities that are not participating in social security would have to be given reasonable time to establish new career retirement programs for those hired after the effective date to take into account social security coverage and provide a supplementary amount such that the total benefits to be received by these new workers in the future would not be less than they would have received had the preexisting system continued and they had not had social security coverage.

But whether or not social security coverage can and should be extended on a mandatory basis with respect to public employees newly hired in the future, the problem of the receipt in the future of weighted social security benefits by current public employees, both federal and non-federal remains. Certainly, those who are already retired and receiving multiple benefits, including a weighted social security benefit should not be disadvantaged. They have only earned what the law permitted them to earn.

But for those who are not yet retired, and who can expect to receive a good staff retirement benefit from their own system, it makes little sense to permit them to avail themselves of the weighted benefit formula. The Congress may have to consider amendments to the law to prevent the accruing of benefit amounts in the case of such persons beyond what is strictly justified on the basis of their contributions. Indeed, as the number of quarters of coverage for fully insured status continues to increase, pressure is likely to build for the creation of a system of financial interchanges between the separate retirement systems such that, when current workers with split employment histories retire, they will receive one primary retirement benefit from their career system that adequately reflects their total contributions.

VI. BENEFIT AND TAX EQUITY ISSUES: ADAPTING SOCIAL SECURITY TO SOCIOECONOMIC TRENDS

A. Structural inequities: Sources of increasing dissatisfaction

There are inequities in the social security benefit structure that stem from assumptions made during the early years of the system's evolution. One of these assumptions was that the man is the breadwinner who is responsible for the support of his wife and children and that the woman is the homemaker. However, over time, the traditional role of the woman has changed to include substantial periods as a wage earner. That social security does not adequately recognize the overlap occurring in the roles of a woman is a source of increasing dissatisfaction.

Under the present law, a woman as the spouse of a fully insured worker, is entitled to 50 percent of her husband's primary insurance amount, even though she made no contributions to the system. A woman worker beneficiary is entitled to benefits based on her own average monthly earnings and any spouse benefit to which she is entitled on her husband's record is reduced by that amount. In effect, she receives the larger of two benefits. However, if she is entitled on her own record, she derives an expanded degree of protection for her spouse and children, but the degree of protection is not congruent with that of a fully-insured male worker.

There are other factors to be considered here. Most working women are employed in lower-paid occupations and industries. Moreover, many women periodically leave the labor force to raise children, but those years of non-labor force participation are included in the computation of benefits. Consequently, the average monthly wage (AMW) of a woman tends to be much lower than that of the man and her own benefit turns out to be little more than what she is entitled to as a dependent. It should not be difficult to understand why the working wife often feels that she receives little or nothing for the taxes she has paid, since the non-working wife can often obtain approximately the same benefit without paying anything.

It must be noted that the working wife has additional protection which is not available to the non-working wife, including disability insurance, lump sum

death payments, and possibly monthly survivor benefits for her family. Also, the wife's benefit as a wage earner is payable upon her own retirement, but her benefit as a dependent is payable only if both she and her husband are retired. The working wife may also receive a greater benefit in proportion to her averages monthly wage than her spouse since social security's benefit structure is weighted in favor of those who contributed less to the system. But, while it may not be valid to argue that women workers as a group receive less for their contributions than men workers do, it is valid to argue that some women, especially working wives, fail to receive the full value for their contributions.

Since the wife is a source of family income, the loss of these earnings, upon retirement, has an impact upon the family unit. While recognizing the importance of the contributions made by the woman homemaker, our Associations believe that the additional contributions of the working wife entitle these women to a more equitable distribution of benefits.

While a major purpose of social security is family income support, the focus in the determination of benefits is the individual, his earnings, and status in the family. The working husband and wife may contribute more to social security than a single worker whose income is equivalent to their combined earnings. It has been shown that where the combined earnings of a couple are below or slightly above the taxable maximum for one worker, the sum of the benefits to which they are entitled is usually smaller than the sum of the benefit to which a man, whose earnings are equivalent to their combined income, is entitled and that to which his non-working spouse is entitled.

B. Widows benefits

The payment of benefits to the surviving wife of an insured worker has always been an issue in any examination of social security. The concern arises as the result of the fact that widows receive lower incomes, possess fewer assets, and are less able to supplement their income.

While a substantial effort was made to improve the adequacy of benefits for widows through the enactment of Social Security Amendments of 1972 (P.L. 92-603), the incidence of poverty among aged single women remains a very serious problem.

C. The male spouse

Very few men receive benefits based on their wives' earnings. Part of the reason for this is that men are more likely than women to have higher earnings. Another reason is the fact that the man, in order to be entitled to husbands' or widowers' benefits, must be dependent upon his wife for one half of his support.

While it is true that the working wife generally receives lower wages than her husband, it is also true that most families are supported by both spouses. The husband may not be dependent upon his wife for one-half of his support, but the loss of the wife's earnings may have an impact upon the family's standard of living.

D. Social security coverage of noncompensatory employment

Under the present social security program, the insured worker is a worker in paid employment. This criterion omits from the program a substantial number of individuals who are in homemaker status or otherwise in non-paid employment. If these individuals in non-paid employment are to be entitled to benefits, such entitlement must be based on their dependency on an insured worker.

It has been suggested that the woman who is working in non-paid employment be entitled to establish social security credits on the basis of work performed rather than wages earned.

Certainly, the services performed by a woman in non-paid employment (i.e. homemaker activities) are essential. Unfortunately, questions concerning the value to be imputed to such work, the matter of contributions, and the cost of such credits, must be resolved before a new criterion can be added.

E. NRTA-AARP recommendations to improve benefit equity

In order to provide full value for the social security contributions of working women, our Associations first recommend that three new classes of benefits be established—for divorced husbands, surviving divorced husbands, and surviving divorced fathers caring of a child entitled to benefits on the earnings record of the deceased spouse. Second, existing dependency requirements with respect to benefits for husbands and widowers should be eliminated.

It has been argued that men cannot be presumed to be dependents and that if the dependency requirement is eliminated, a substantial percentage of men would qualify for benefits even though they are working in non-covered employment. We expect, however, that a retirement test will continue to apply to secondary benefits (even though we want to see it liberalized and ultimately abolished with respect to primary benefits) that will preclude receipt of such benefits by most working men. Also, to prevent a husband (or a wife) from receiving a secondary benefit on his (or her) spouse's earnings record while receiving a primary benefit from civil service retirement or some other non-social security retirement system, the Congress will have to consider the Social Security Advisory Council's proposal to phase in provisions that would reduce or eliminate secondary social security benefits in such cases.

To deal simultaneously with the complaint made by working wives that their contributions to social security are wasted because the benefit they receive is often no greater than the benefit they could have received on their husband's record without any contribution on their part and with the complaint that two-earner families receive less in total benefits than a single-earner family in certain cases, our Associations are inclined to support a proposal advanced by former Social Security Commissioner Robert Ball to increase primary benefits by approximately $\frac{1}{8}$ and reduce secondary benefits to spouses from $\frac{1}{2}$ to $\frac{1}{8}$. Such an increase is, of course, implied in our proposal for a decoupled system benefit formula that replaces not less than 55 percent of preretirement earnings. This proposal would also have the desirable effect of increasing survivor benefits. However, because the proposal could deliberalize benefits for a divorced spouse, such an effect would have to be prevented through modifications in their benefit amounts.

Our Associations continue to advocate that the age 62 computation point be applied to men who reached age 62 before 1975. The adoption of this proposal would aid dependents and spouses of older men who have low benefits because they worked during periods when wage levels were lower; moreover, it would eliminate an inequity in the treatment of men.

Our Associations also believe that the duration of marriage requirement for divorced spouse benefits should be reduced. It is presently twenty years.

In order to lessen the adverse impact upon the primary retirement benefits of women who leave the work force for extended periods to raise children, our Associations have expressed support for the introduction of some form of an earnings record "freeze" (such as that applied to periods of disability) applicable to periods during which the woman is raising a family.

In the area of disability, our Associations recommend that: (1) the "recent covered work" test used to determine eligibility for disability insurance benefits be eliminated in order to aid those middle-aged workers who have gradually become disabled; (2) an occupational definition of disability for workers age 55 and over be used; (3) reduced wife's and husband's insurance benefits be made available in the case of disabled wives and disabled husbands who are age 50 or over; and (4) disabled widows (and widowers) and disabled surviving divorced wives (and husbands) be eligible for benefits without regard to age and without actuarial reduction.

F. NRTA-AARP recommendations to improve tax equity

While we recognize that a major reform in federal tax policy was achieved with the creation of the earned income credit of I.R.C. § 43, the credit is only temporary and is only available to workers with dependent children in the home. Our Associations, as part of our recommendations for federal income tax reform, have urged that the credit be made permanent and available to individual workers and families without children. The general decline in the proportion of federal revenue raised by progressive income taxes and the increasing portion raised by regressive payroll taxes means that over time, the federal revenue system, as a whole, has become less progressive.

Since the earned income credit (which is refundable) in effect integrates the federal income and payroll tax structures and provides relief from the latter for lower income wage earners, our Associations consider this provision a desirable application of the ability to pay principal.

Chairman HUMPHREY. We do thank all three of you for your testimony. And I want to say to Miss Miller particularly that the emphasis

that you have placed upon some confidence in the system I think is much needed as of now.

The mail that comes into our respective offices I think demonstrates the concern, the emotions, and the force that many of our senior citizens have about what they have been reading, and about the social security system.

Do I correctly understand, Mr. Ball, and the other witnesses, that we presently have about a \$40 billion reserve in the trust fund?

Mr. BALL. That is correct, in the cash benefit trust fund. There is another \$81½ billion in hospital insurance under medicare.

Chairman HUMPHREY. And as you have stated, and I think all three of you have made this point, during periods of recession you would expect that you might have some deficit, and that a trust fund is there for a purpose of being able to absorb that deficit, is that correct?

Mr. CRUIKSHANK. Yes; that is quite correct.

Miss MILLER. I think one of the problems, Mr. Chairman, is that we have misled the people into thinking that the Trust Fund is a pot of money out of which each and every individual benefit is paid.

We have failed to educate people that the Trust Fund is there as a reserve to pay deficits.

So, when scare headlines come out, such as the trust fund is going broke, or social security is going broke, people don't realize that social security is a pay-as-you-go program, that it is a current financing program. They think the money has disappeared and they are not going to have benefits. And this is where we have to do some reeducation.

Chairman HUMPHREY. The concern is that over the longer period of time that if you continue to have deficits and you do draw down the Trust Fund, and therefore the suggestions that Mr. Ball has given in the picture does make sense. And let's get those suggestions clear in the record.

The first is decoupling, which is basically what Senator Bentsen has offered in the Senate Finance Committee.

Mr. BALL. Yes, sir.

Chairman HUMPHREY. What we call the wage replacement rate in the future.

Mr. BALL. Yes, sir. The ratio of the benefits that people get to their recent wages.

Chairman HUMPHREY. And secondly, you have advocated a gradual increase in the wage base.

Mr. BALL. Over and beyond the automatic—

Chairman HUMPHREY. Over and beyond what is now in the law, the automatic increases?

Mr. BALL. Yes.

Chairman HUMPHREY. When you say gradual; over what period of time are you talking, Mr. Ball?

Mr. BALL. Well, to get back to the coverage of 95 percent of workers having their full wages counted—if you did it in one step, it would call for about \$24,000 next year. And instead of that we will be at \$16,500 next year.

Now, what I propose is going up an excess of about \$3,000 a year. Of course, that \$24,000 figure increases year by year as average wages go up. So that by the time you reach 95 percent the figure will be

higher than \$24,000. And so, on this gradual basis I propose, it would probably take you three or four years to reach the point where you had 95 percent of the workers with all wages covered.

Chairman HUMPHREY. Your third proposal was, you had decoupling and increased the wage base.

And what was the third? The 1 percent?

Mr. BALL. Right. Then I would move the rate up that is already in the present law. And with the whole combination, Mr. Chairman, you could say that without any additional sources of revenue, and without increasing the contribution rate any more than it is scheduled in the present law, you would have restored the financial stability of the system for the rest of this century. And then we talked about what might be done as far as the next century is concerned.

Mr. CRUIKSHANK. There is an additional factor that if you raise the wage base you also get additional income for the other parts of the system like medicare. You could improve the Medicare system without increasing the rate if you increase the wage base.

Mr. BALL. That is a very important point, Mr. Chairman. Actually, if you took a fairly sizable increase in the wage base it would be possible to pass this year what I think is the good part of the President's medicare proposal, the limitation on what older and disabled people have to pay for long stays in the hospital, without needing to depend for financing on what I think are the bad parts of his proposal, increasing coinsurance for people who have short term stays.

On this longer run thing—

Chairman HUMPHREY. How much longer run are you talking about?

Mr. BALL. I am really talking about the last 50 years of the trustees estimates, beginning about 200. I can't stress too strongly that the problem of demography is almost entirely in the next century as far as the system is concerned. It has very little affect any sooner—maybe a slight affect in the last 10 years of this century, but not much.

These big deficits that are talked about relate entirely to the large number of older people, expected beginning about 2005 and then, a much more difficult thing to predict, how big the labor force is going to be to support those older people. That is the part that is uncertain. And I would propose, Mr. Chairman, that just to reassure people about this long-run situation, in addition to working on retirement policy, that you might want to give consideration to restoring to the Social Security Act a provision that used to be in the law for many years—provision which said, in effect, that there would be available to underwrite the benefits of social security the general revenues of the Federal Treasury if they were needed under any circumstances. In this way people could always be sure that there was no possibility of any so-called default on social security promises.

I don't think general revenues will be needed at least in this century, but I might be reassuring to put that guarantee back into the law. I do not myself resist the idea for the long-range future, if it is needed, of having some general revenues in the system.

Chairman HUMPHREY. You noted in your testimony, you called it to our attention, the typographical error, the fact that certain other countries do have a kind of tripartite arrangement with general revenues, employer and employee. What are those countries specifically?

Mr. BALL. Well, almost all of them if you take into account all the risks covered. There are some countries, however, such as France and the Netherlands that do not have specific government contributions for their old age and survivorship system. But most countries do, either by a direct contribution as in England and Germany or paying for a universal flat pension which forms a base for the contributory wage related system as in Denmark. Many countries have pledged general revenues to make up for any deficits—Canada, Austria and others.

Chairman HUMPHREY. Does that cause any problems of consequence?

Mr. BALL. No; I think it is really a helpful thing. The only reason I didn't recommend it right away is that there are so many other demands on general revenues. I am very much in favor of getting a national health insurance system started. And I think that a significant part of the cost of such a system is going to have to come out of general revenue. I think it is very important to the country that we improve the welfare system, and that Federal support for welfare be increased. That is going to cost some general revenue money. So, I would like to carry the cost of contributory social insurance in the traditional way at least through the next 25 years. We will know more then about the size of possible deficits—or if the system has been improved and requires more financing. If needed we can justify a general revenue contribution as going for that part of social security which is socially determined—the weighted benefit formula for the lower paid worker and additional protection for those who have dependents.

Chairman HUMPHREY. Just one question more. As you know, there is a strong income redirection aspect of the social security system that has been emphasized in testimony here, and that is, when low-income workers to which we have just been referring retire, their social security benefits are proportionally larger than the retired higher income individual. And this feature is designed to provide a certain minimum amount of income for retired elderly persons.

However, since the implementation of the supplemental security income program such as SSI, some have argued that we should use SSI to provide minimum benefits for retired low income persons. They argue that the social security should be more of an income insurance program, and that SSI should be the income redirection or minimal income support program. How do you feel about that suggestion?

Mr. BALL. I have two reactions, Mr. Chairman. First of all, as far as the regular minimum benefit in social security is concerned, I think we can say that that has outlived its usefulness. And I would be pleased to see that minimum frozen at its present dollar level for future beneficiaries. Then as earnings go up and people get higher benefits it would just phase out. But I am not in favor of dropping the weighted part of the social security benefit and making the system strictly wage related for everyone. The supplemental security income program is an important program, but it should be needs tested. I would like to see these programs be required to meet a needs test to the absolutely irreducible minimum. I think people who have paid social security contributions all their lives ought to be able to get a

social security benefit that is more than enough to meet the absolute poverty standard. Therefore I would not favor dropping the weighted benefit concept and relying entirely on an income tested program for low earners. They could well feel that they got very little for their social security contributions.

Chairman HUMPHREY. Senator Javits.

Senator JAVITS. I will only take 1 minute, Mr. Chairman.

I was impressed by your feeling that we ought to restore a pledge to use general revenues if necessary in order to restore confidence in the system. I am worried about that standing alone. I respect you enormously, and your colleagues at the table. What would you say to the policy declaration, and whatever we adopt, which affirms our faith in contributory system which states as a principle that we should be increasing the wage base, and we should be increasing the contribution rates, and hopefully without a shock to the system, as Commissioner Cardwell described it, but in the final analysis this country stands behind the process of the social security system and will redeem them even if it calls for general revenue type answering in part?

Mr. BALL. Yes, Senator Javits, that is the sort of provision I would have in mind. It would be a last resort provision. And if you make these other changes, I am not sure it would ever have to be called on, and certainly not until the next century.

Senator JAVITS. May I submit—and perhaps others will join with me, hopefully some of those here—a declaration of that kind to you. And would you be good enough to help us to get one out that meets this kind of experience that you have?

Mr. BALL. Certainly.

Chairman HUMPHREY. Senator Proxmire.

Senator PROXMIRE. I will be as brief as I can.

I would like to ask you if any of you would like to comment on what is happening to our tax system as a result of the heavy reliance on the social security system. I notice that in comparing the proportion that OASDI represents of the personal income tax, for example, that whereas in 1967 it was 40 percent of the personal income tax, in 1975, the last year for which I have figures, it was 50 percent. Now, if you compare it with the corporate income tax, in 1967 the corporate income tax yielded \$34 billion, and OASDI \$25 billion.

In other words, the corporation income tax yielded 30 percent more. But in 1975 OASDI yielded \$64 billion, and the corporate rate income tax only \$41 billion.

So, here you have a situation where we are getting 50 percent more from OASDI than we are in corporation income tax, a dramatic shift in the incidence of taxation, and a regressive result in our income taxes, requiring people with modest incomes to pay a far higher proportion of the taxes paid to their Federal Government. It is true, it is a social insurance system.

Nevertheless, we can't blink at the effects that this has on tax equity. How about it?

Mr. CRUIKSHANK. I think your last remark is in part an answer to your question. Because to a certain extent in the whole budget picture you are adding apples and oranges. Until 1969 the trust funds were separately reported, separate from the administrative budget. We felt

that it was a mistake ever to put it into this consolidated budget, so that you get a mixture of things.

Now, I would respectfully suggest that the issue of the social security tax being higher in many respects than an income tax is rather irrelevant. There are lots of things that are higher than income tax. People may pay more for transportation than they pay for their income tax. They may pay higher for shelter. And it is a question of how much of their family income they are willing to allocate to economic security.

Senator PROXMIRE. It is not a matter of how much they are willing to allocate, they obey the law. And we make the law.

Mr. CRUIKSHANK. It is up to our legislative representatives to make that decision. And the fact that we as a people have decided to make that allocation out of our resources toward the maintenance of income security seems to me to be significant.

Senator PROXMIRE. This is what Mr. Ball commented on, and I was sympathetic with his distinction. Several years ago I put Mr. Ball's statement on this problem into the record. It goes to the heart of the problem of whether or not we should rely more on general revenues. That is a progressive tax if we do that, it is not a regressive tax, as the payroll tax is. And this is another consideration here. I realize that the dignity and the benefit of people being able to pay in and get back what they paid in and having it as social insurance system, I am all for that. But, you can't escape the fact that this is a regressive tax hitting low income people, disproportionately and unfairly, when you rely as heavy as we do on the OASDI.

Mr. CRUIKSHANK. Looked at as a tax alone it is regressive, to be sure. And I certainly wouldn't want to be on record as supporting the financial structure as it is without any changes.

I think, for example, the forgiveness of the tax that was enacted last year could very well be continued. I think that there should be some relief for the low income people. And this also would perhaps be a part of the support for the system of general revenues. Raising the wage base also makes it more progressive on the tax side so that I think we need to make some changes in the financial structure of the system, even assuming that it is going to continue to be internally financed as it is.

Senator PROXMIRE. Just one other question. The rollcall is on.

I think I must have misunderstood you to say that people should not receive more in benefits than their highest salary. Was that your statement, or did I misunderstand it?

Mr. BALL. Yes; I think it would be unwise to allow a system to go into effect—

Senator PROXMIRE. That depends entirely on inflation. Somebody retires at 65 and earns \$4,000. In order to get the equivalent of \$4,000 with 10 percent inflation compounded, he would have to get \$20,000 when he is 85 years old.

Mr. BALL. You and I are in complete agreement, I must have mis-spoken if you got a different impression. I meant that at the time of retirement, you don't want to have at the beginning higher retirement pay than previous wages.

Senator PROXMIRE. But, if the inflation was serious enough you would have to pay more than the retirement?

Mr. BALL. Yes. You would have to keep the benefits up to date.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman HUMPHREY. We have Congresswoman Heckler with us. And she may be required to close off this hearing, but that is her special privilege.

Congresswoman Heckler.

Representative HECKLER. In the interest of time, because we probably will have a vote shortly in the House as well, I have to say that I have enjoyed all the testimony and the innumerable questions. But, for the record, I would like to ask you to state some of the instances of discrimination against women in the social security system with which you are familiar.

Miss MILLER. Of course there is the problem of divorced women and the homemakers who are not protected under social security. I think this is one of the issues that Congress does need to address itself to.

I realize this is a tough one. I am told that homemakers were not included originally because no one could figure out how to do it, and they still haven't figured how to do it.

But, to illustrate the problem of unpaid women in the home—take, for example, a woman who becomes divorced after 19 years of marriage; she has no social security benefits despite the fact that she has made a substantial contribution to society in maintaining a home. There is also the problem of the woman without dependent children who is widowed, say, at the age of 52: She has no benefit whatsoever under social security until she becomes 60. There is a period of time in which such a woman must adjust to an entirely different kind of life style, without benefits.

And there is the problem of the two-earner family. In some instances a wife works, and makes a full contribution to social security, but when she goes to collect her benefits she can get a benefit no larger than 50 percent of her husband's. In effect, her contribution to the social security system has disappeared.

I think Mr. Ball has an interesting proposal in that regard under which the primary benefit would be increased, and the benefit for a couple would be decreased. I think instead of being 1½ percent it would be 1⅓ percent. This increase in the primary benefit would help the single working woman and, it would help the married women in the two-earner family, and the widow. So, I think it is a meritorious proposal, and one that you may well want to consider.

There is some tendency to blame social security for certain discriminatory situations as far as women are concerned which are really not social security problems. The woman who is paid far less than the man for the same job of course ends up with a smaller benefit. And this translates into a very serious problem for older women; their benefits are much lower because they had low earnings. I don't believe we can blame that on the social security program. It is the result of a discriminatory situation outside of social security.

Chairman HUMPHREY. I want to personally express my thanks to you. You have been most helpful. And I hope that you will continue to answer Congresswoman Heckler.

Will you close the hearing for us?

Representative HECKLER [presiding]. Yes. I have only one further question.

Mr. Ball, what would be the effects of the equal rights amendment on the social security law?

Mr. BALL. It would require three important changes, and several relatively minor ones. And I think the changes ought to be made without waiting for any equal rights amendment.

Representative HECKLER. So, you advocate changes?

Mr. BALL. I think we ought to eliminate the last vestiges of sex discrimination. In fact, I would favor going through the Social Security Act and removing gender as a term in the law wherever we can possibly do that. Where this would have perhaps the most effect is that today a husband's benefit and a widower's benefit is payable only on the basis of a demonstrated dependence on the female wage earner, whereas in the reverse situation there is a presumption of dependence. So, I would favor removing the proof of dependency and paying benefits to a widower and to a husband under the same circumstances as to a wife and widow. That would be two of the important changes.

The other instance, interestingly enough, would be in favor of men—the other most important change—because there is a discrimination against male workers in the present law. The situation has been corrected for the future, but all men who were born before 1913, I believe, find that they have a computation period which is longer than that for women. For such men the average monthly wage is computed up to age 65 instead of 62. The result of the larger computation period is to lower the average wage. One has to count 3 more years in the average and the result is a lower average wage. That would have to be changed under the equal rights amendment. And there are cases in the courts on all three of these provisions right now. I think they ought to be changed by legislation.

Representative HECKLER. I see.

Have you formulated any of these proposals in terms of testimony before a congressional committee or any other presentation to the Congress?

Mr. BALL. Yes. And the last place where these were gone into at considerable length was a hearing before the Senate Committee on Aging on a report of a panel that the Senate Committee on Aging had set up on the treatment of women under social security. And several of us testified on that. I think my two colleagues at the table both testified, and many other witnesses. All of these proposals are both in the report and in the record of the hearing.

Representative HECKLER. One further question, Mr. Ball. On the possible limitations, should New York City terminate its participation in the social security system, what would the implications be for the system, and how would that affect the forecast that you have given us?

Mr. BALL. Could I talk first about State and local employees in more general terms, and then come back to New York?

It seems to me very bad public policy for us not to have included Government employees, Federal and State and local, on a universal basis under social security—on a compulsory basis. State and local

employees were not covered compulsorily because, at the time, it was thought that it might be unconstitutional to cover the States, on a compulsory basis, by Federal law. Many people now feel that the case ought to be tested before the Supreme Court and see if it couldn't be done.

There are 30 percent of State and local employees not covered by social security, the rest have been brought in by voluntary agreement. And, of course, Federal employees are not covered. Those who are not covered by social security, nevertheless, to a very considerable degree pick up enough social security credits to get benefits, but their benefits are figured on the average that they have under the social security system. To the system, they look like wage earners. They haven't paid in over their whole lifetime; they have just paid in when they worked in covered employment. Thus, the heavy weighting in the social security benefit formula gives them an advantage compared to what they paid in. The net result—the way to say this in summary terms is that Government employees are getting an advantage that is the equivalent in the long run of almost a half percent of payroll.

In other words, other people are paying for this windfall that Government employees are getting. I am in favor of universal compulsory coverage, then modification of government systems so as to be supplementary to social security just as the American Telephone and Telegraph system and other private plans are built on social security.

Now, if that can't be fully accomplished—and I recognize considerable political difficulty with it—there are things that can be done nevertheless to eliminate this windfall that I am speaking of, and protect the social security system against the unfair advantage that those government employees have who are not covered under social security.

There is the problem that is created by the threat of withdrawal as well. Withdrawal has a similar effect. From the system's standpoint, it increases the number of people who can pick up coverage on a minimum basis.

But, I would also want to stress that from the standpoint of the employees, the great bulk of the employees, it is also going to be very disadvantageous. They lose disability protection, and survivor's protection, as well as retirement protection. It is an important issue. In the short run, the social security system would lose substantial income in terms of just New York alone. The Commissioner, I believe, in his statement included a figure on loss of premiums which I don't have in my mind. For the long run withdrawal increases the unfair loss to the system that I referred to earlier. Even the present partial coverage costs social security as much as a half percent a payroll. If no government employees were covered, it would be much more.

Representative HECKLER. Thank you.

Mr. Cruikshank, I want to give you equal time. And I am sure you have some final thoughts that you would add to the record. And if so, feel free to do so.

Mr. CRUIKSHANK. Thank you very much.

I will forgo the privilege of equal time, since my colleagues have said just about the same things I would say anyway, unless there are other questions. And I appreciate your courtesy, Mrs. Heckler. But I won't take advantage of it at this time.

Representative HECKLER. I have so many retired members in my district that I dared not pass you up.

Mr. CRUIKSHANK. And friends of yours too, Mrs. Heckler.

Representative HECKLER. I thank the witnesses for your contributions today and for your testimony.

The hearing will be recessed until 9:30 tomorrow morning in this same room, where the subject matter will be continued.

[Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 9:30 a.m., Thursday, May 27, 1976.]

THE SOCIAL SECURITY SYSTEM

THURSDAY, MAY 27, 1976

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 9:36 a.m., in room 1202, Dirksen Senate Office Building, Hon. Richard Bolling (vice chairman of the committee) presiding.

Present: Senator Percy; and Representatives Bolling and Long.

Also present: Louis C. Krauthoff and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; and Charles H. Bradford, George D. Krumbhaar, Jr., and M. Catherine Miller, minority professional staff members.

OPENING STATEMENT OF VICE CHAIRMAN BOLLING

Representative BOLLING. The committee will be in order. Good morning, ladies and gentleman. Welcome to the Joint Economic Committee's second and concluding hearing on social security. We have an unusually distinguished panel of witnesses here with us to discuss steps to improve the social security trust fund's position. After yesterday's Wall Street Journal editorial on the alleged \$4 trillion unfunded liability, a lot of people are going to need reassurance that all of their contributions are not being wasted. One of the principal reasons for these hearings is to restore confidence in the system.

There are a number of possible paths to follow to restore balance to the short-run deficiencies in the system. It is clear from comments by our committee members yesterday that all felt a strong obligation on the part of the Congress to insure that the social security system performs its tasks.

All of us have large constituencies of current recipients and theoretically all of our districts are composed of future recipients. I do not think there is cause for great alarm and I am confident that with the help of witnesses like yourselves, we can resolve the problems before us judiciously.

Our witnesses before us this morning are Mrs. Alice Rivlin, Director, Congressional Budget Office; W. Allen Wallis, chancellor, University of Rochester and chairman of the 1975 Advisory Council on Social Security; Robert Tilove, senior vice president of Martin E. Segal Co.; and Martin Feldstein, professor of economics at Harvard University.

**STATEMENT OF HON. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL
BUDGET OFFICE**

Mrs. RIVLIN. I will not read all of my statement, but I do want to read some of it. I hope the remainder will be included in the record.

Representative BOLLING. It will be included in the record at the conclusion of your testimony.

Mrs. RIVLIN. I appreciate this opportunity to discuss with the Joint Economic Committee the financing problems confronting the social security system.

Over the next few years, the reserve funds of this system will be reduced because of the combined effects of inflation and recession. This depletion was to be expected. The crucial questions that need to be addressed are how long the trust funds' reserves will continue to be depleted and whether they will be replenished as the economy recovers. Predictions on the status of the trust funds' reserves in the early 1980's largely depend on the assumed future inflation and unemployment rates.

However, while the stability of the trust funds' reserves over the next 5 to 10 years will depend most heavily on overall economic trends, other major factors affect the financial strength of the system in the future.

Under any set of reasonable economic assumptions, it is clear that the current tax and benefit structure will not maintain the trust funds' solvency in the long run.

The reasons for this are twofold:

One: The ratio of beneficiaries to workers will rise substantially after about 2012.

Two: A flaw in the benefit computation formula will increase retirement benefits relative to earned wages especially after about 1995.

These two factors have a significant impact on the future balance of trust fund income and outgo.

To correct these longer-run problems, changes in the benefit and/or tax structure are necessary, but need not be made immediately. However, because any legislation that corrects for the consequences of actual economic trends will affect the trust funds' reserves, into the distant future, there is both the need and the opportunity for the Congress to consider the entire set of remedies together.

THE SIZE AND NATURE OF THE FINANCIAL PROBLEMS

The tax and benefit adjustments enacted in 1972 would keep the funds in balance, on the average, if two economic assumptions prove correct:

One: That total wages subject to the payroll tax, on the average, increase by six percent annually because of increases in employment and current dollar wages; and

Two: That prices, on the average, increase at 4 percent annually.

Whether or not the reserves are depleted depends upon the actual performance of the economy. If total wages increase more slowly, then revenues will be reduced. Also higher rates of inflation mean higher trust fund outlays.

Between fiscal years 1970 and 1975, the trust funds' reserves increased from \$37.7 billion to \$48.1 billion. However, because the trust funds' outlays increased from \$30.3 billion to \$64.7 billion over the same period, the reserves as a ratio to current year's benefits fell from 125 percent to 75 percent. This substantial decrease in the ratio of reserves to annual benefits occurred as a result of both a shortfall in expected revenues, caused by high unemployment, and an unusually large increase in benefits, caused by rapid price increases.

Past inflation rates increased the base level of benefits, and it is largely because of this that absolute decreases in the funds' reserves can be expected over the next few years. But even this absolute reduction in reserves is not necessarily an indication of insolvency.

The purpose of a reserve in a pay as you go program is to cushion short-term financial shocks. Hence, the system is in need of adjustment only if:

The financial condition is getting worse and gives no sign of correcting itself; or

While capable of correcting itself, it appears to be running out of funds before it can correct itself.

A separate but very important factor with a strong bearing on the trust funds' deficit over the next 5 years is the unforeseen and as yet unexplained rise in disability insurance costs. Because disability insurance may require special treatment of both an administrative and structural nature, it is preferable to discuss separately the OASI, the Old Age and Survivors Insurance Fund and the DI, the Disability Insurance Fund.

OASI FUND OVER THE NEXT 5 YEARS

The prognosis for OASI over the next 5 or so years depends upon macroeconomic events.

Table 1 compares the administration projection, intermediate assumptions, and CBO's most recent estimate. The key difference in the assumptions is the higher inflation estimates of the administration for fiscal years 1977 through 1979. The effect of this is to provide higher cost-of-living increases to beneficiaries, so that by 1981, the administration's estimates of fund disbursements is almost \$4 billion higher.

As can be seen from table 1, both sets of projections show an annual deficit in every fiscal year from 1976 to 1981, although the CBO estimates reserves at the end of fiscal year 1981 of \$31.4 billion, which is about \$7 billion higher than the administration's, mainly because of the lower rates of inflation assumed. Under both the administration and CBO projections, the reserves at the end of 1981 will be less than one-third of the annual benefits paid out.

What is more disturbing than the continuous depletion of reserves during this period is the lack of a distinct turnaround in the reserve situation. Indeed, the administration's annual deficits appear to be growing larger. In the CBO projections, the annual deficit falls from \$1.1 billion in fiscal year 1979 to \$0.3 billion in fiscal year 1980, but rises again in fiscal year 1981 to \$1.4 billion. This increased deficit in 1981, however, results from the legislated decrease in the OASI tax and not from changed economic assumptions.

These projections raise questions about whether the automatic adjustments currently built into the social security system are adequate to maintain the solvency of the fund over the next 4 to 10 years. Indeed, the administration has shown under pessimistic economic assumptions for inflation and particularly unemployment, that the OASI reserves could be exhausted by 1981. Of course, under more optimistic assumptions—that is, lower inflation rates and lower unemployment rates—a rebuilding of the OASI reserves would be projected.

OASI BEYOND THE MID-1980'S

If favorable economic conditions continue, then revenues could be increased to cover the shortfall in the near future. But small changes in revenues will not solve the deficit problem foreseen for the next 75 years.

The long-range deficit will require much more basic changes. The combined social security payroll tax rate (OASDI) is now 9.9 percent and will rise to 11.9 percent in the year 2011 under current law. In order to keep the funds in balance under current law, tax rates would have to be increased by 75 percent, averaging about 19.96 percent over the next 75 years.

This is principally because of two factors: First, revised demographic projections which show fewer persons of working age compared to the number of social security beneficiaries; and second, a defect in the automatic adjustments to the benefit formula written into law in 1972, containing an annual adjustment which causes future benefits to grow so rapidly for some groups that they will certainly exceed wages at retirement.

The seriousness of this problem was first brought to public attention in the 1975 trustee's report.

The social security benefit computation formula is simply an equation to determine how much of the earnings that were lost by retirement, death or disability will be replaced by the benefit. The summary question is:

Average lifetime wages times wage replacement factor¹ equals benefit amount.

Under the statutory change made in 1972, whenever benefits for those already on the rolls are increased to keep pace with the cost of living, the wage replacement factor is also increased at the same percentage. This was established to assure that every future retiree who had the same average lifetime wage as a current retiree could receive the same benefits. This adjustment or indexing overlooked the fact that average lifetime wages of the future retiree are also rising and therefore, the benefit formula is actually overadjusted. Chart 1 illustrates this problem.

Until about 1995, the overadjustment compensates for a different adverse phenomenon, the lengthening of the period over which wages were averaged. In 1950 the Social Security Act was amended so that the averaging period would include only those years after 1950. This means that until 1995, when the period stabilizes at 44 years, the aver-

¹ The wage replacement factor is the percent of average monthly wage to be replaced by benefits. It is not a single value. It is graduated into different values over dollar range brackets so that persons with lower wages get a higher percentage of their former earnings replaced.

aging period will increase and, therefore, the average lifetime wage and the unrelated benefit level would become smaller as a percentage of final wages.

As a result, simply eliminating the indexing of the wage replacement factor, commonly known as "decoupling," would, if no other adjustment is provided, decrease the ratio of retirement benefits to final wages.

Let me skip over the problem of disability insurance but note that there is a serious problem in the disability fund. We are a little bit more pessimistic than this administration on this one although we are less so on OASI.

COMBINED OASDI TRUST FUND RESERVES

The OASI fund is likely to have between \$23 billion and \$31 billion in reserves by 1981, and the combined reserves of OASI and DI trusts could be between \$15 billion and \$16 billion. Even at this level of reserves, it would appear that the combined trust fund revenues will be adequate for the next several years under all but the most pessimistic assumptions. However, if the annual deficit in DI continues at a rate of \$4 billion to \$6 billion, then the combined OASDI trust fund reserves could be depleted within a few years.

While such a prognosis does not necessarily warrant action this year or next, it is likely that steps will have to be taken within the next 5 years, if for no other reason than to correct for the deficiency in the DI fund. Congress could wait 5 years or more to determine how the long-term solvency problems should be handled. However, this might unnecessarily heighten public concern, particularly for those who depend on social security for retirement income.

POSSIBLE REMEDIES: IMMEDIATE PROPOSALS

One option before the Congress is the President's proposal contained in the fiscal year 1977 budget. The proposal would increase the OASDI payroll tax by 0.3 percent of earnings subject to tax for both employer and employee and institute certain long range reductions in benefit eligibility.

Some may object to this approach, not only because of a disagreement about the need for action in this session, but because of the nature of the immediate action. An increase in the tax rate aggravates the regressive nature of the payroll tax and could increase inflationary pressures in the short run.

As an alternative, tax revenues can be increased, still within the payroll tax structure, by increasing the amount of earnings subject to tax. That has the problem that it also increases future benefits and under the current program structure it runs the danger of increasing the long run deficit.

Other possibilities are:

(1) Provide a grant from general revenues. The amount needed, if no other remedies were adopted before 1981, would range from zero under the most optimistic economic assumptions to \$13 billion under the administration's most pessimistic assumptions.

(2) Emergency borrowing authority from the general fund. Con-

gress could provide a limited authorization to cover temporary deficits by borrowing from the U.S. Treasury. Unlike an outright grant, it would permit the system to retain its self-financing structure while at the same time avoiding the long-term measures to correct short-term crises. Provisions of this type have been enacted in the past but have never been used.

STRUCTURAL REFORMS

We think the Congress should look at longer term or structural changes in the system, which include higher levels of revenues or lower levels of benefits. Higher levels of revenues may be achieved either by increasing the payroll tax or by some support from general revenues. Lower levels of benefits may be achieved either by a general reduction in benefit levels—lowering the ratio of benefits to final wages—or by selective reductions in eligibility and entitlement—reducing the progressive nature of the benefit, shifting some dependency and survivor benefits to other programs.

The magnitude of the structural changes in revenues or benefits depends upon the extent to which revised economic assumptions differ from those now used in the social security system.

HIGHER LEVELS OF REVENUES—INCREASES IN PAYROLL TAX

If the entire deficit were to be remedied by a one-time increase in the payroll tax rate, it would require an increase of 6 percent of taxable payroll in the OASI fund—63 percent higher than the current rate—and 2 percent of taxable payroll in the DI funds—128 percent higher than the current rate.

This would solve the problem but it would build up a huge surplus in the fund over the next few years. If, however, one decided simply to wait and raise the payroll tax when the deficits appeared, the increase would ultimately have to be larger.

If one did it this way, the combined tax rate would climb to almost 29 percent of wages, a rate which would seem intolerable.

SUPPORT FROM GENERAL REVENUES

There has long been controversy about the propriety of adding revenues to the system from general revenues. Those who argue against it defend their position mainly on the need to preserve the integrity of the self-financing system.

Those who argue for general revenue support defend their position mainly on the basis that a very large part of the benefit commitment is not entirely wage related, but also includes income redistribution from the richer to the poorer participants. Under these circumstances, it is said to be inequitable to support such transfers of income with funds raised by regressive taxes, particularly when higher incomes derived from sources other than wages are not taxed.

LOWER LEVELS OF BENEFITS—GENERAL BENEFIT REDUCTIONS

Most proposals for correcting the benefit computation formula would eliminate the indexing of the wage replacement factor—the relationship of benefits to average wages—and replace it by indexing

the earnings history. Indexing earnings history translates each past year's earnings by the growth that has taken place in some other economic factor.

The two most popular alternatives for indexing earnings history are to index by (a) wages or (b) prices. The differences between them may become an important issue. These would have different effects over the long run as wages rise faster than prices.

Under wage indexing, all prior year wages would have the same comparative value as wages carried in the year before retirement. This approach would eliminate half the deficit. Earnings history could also be indexed by price. Since prices over a long period of time do not grow as rapidly as wages, the relationship of benefits to final wages—the wage-replacement ratio—would decline continuously over time.

Therefore, all other things being equal, price indexing develops more savings. It could therefore be employed to eliminate the entire deficit by itself. One should recognize, however, that this would be tantamount to an across-the-board reduction in benefit commitments for future retirees. This is the exact situation that many fear: Although taxes will remain high, future social security benefits—as a percentage of final wages—will be drastically reduced.

SPECIAL REDUCTIONS IN BENEFITS

Except for those changes in the benefit computation formula which would involve drastic future reductions in benefits—as a percentage of final wages—indexing benefits will eliminate only about half of the long-term deficit. Other options to reduce benefits for more narrowly targeted groups should be considered.

For example, a large part of the costs under this system consists of income transfers from high-wage earners to the low-wage earners, or to the dependents of retired workers. The degree to which these transfers occur and are desirable rather than in other public assistance systems is worth considering because:

First. Social security is an inefficient system for delivering assistance to the poor; it uses average lifetime earnings as a criteria for current need, providing costly windfalls to some nonneedy.

Second. Particularly when the system is in serious deficiency, it may be appropriate to shift the financing of non-wage-related benefits to other programs, paid out of general progressive taxes, rather than finance these benefits from the regressive payroll tax.

Third. There may never be a better opportunity than now, when there is a visible need to reduce costs, to reexamine the involvement of this system in providing minimum income to all social security beneficiaries.

While it is possible to consider the structural proposals separately, this would not be advisable. They interact with respect to which individuals would be affected and by how much; with other income transfer programs; and with some of the immediate actions being proposed.

In summary:

(1) While it does not seem to be necessary to act immediately to avoid undue risk to the short-term status of the fund, action is likely to be needed within 5 years.

(2) It is desirable to consider measures that could be taken immediately in terms of their interaction with permanent structural changes.

(3) Changes in the benefit computation formula, while necessary, are probably not sufficient to solve the long-term deficit.

(4) There is time to consider other major permanent changes of a structural nature which, together with changes in the benefit computation formula, would be sufficient to restore long-term financial stability to the program.

(5) This may be the most appropriate time for the Congress to think through a complete set of changes which would be adequate to solve the total financial problem while improving the equity of this important program.

Thank you.

[The prepared statement of Mrs. Rivlin follows:]

PREPARED STATEMENT OF HON. ALICE M. RIVLIN

Mr. Chairman and members of the committee: I appreciate this opportunity to discuss with the Joint Economic Committee the financing problems confronting the social security system.

Over the next few years, the reserve funds of this system will be reduced because of the combined effects of inflation and recession. This depletion was to be expected. The crucial questions that need to be addressed are how long the trust funds' reserves will continue to be depleted and whether they will be replenished as the economy recovers. Predictions on the status of the trust funds' reserves in the early 1980's largely depend on the assumed future inflation and unemployment rates.

However, while the stability of the trust funds' reserves over the next five to ten years will depend most heavily on overall economic trends, other major factors affect the financial strength of the system in the future. Under any set of reasonable economic assumptions, it is clear that the current tax and benefit structure will not maintain the trust funds' solvency in the long run. The reasons for this are two fold: (1) the ratio of beneficiaries to workers will rise substantially after about 2012; (2) a flaw in the benefit computation formula will increase retirement benefits relative to earned wages especially after about 1995. These two factors have a significant impact on the future balance of trust fund income and outgo.

To correct these longer-run problems, changes in the benefit and/or tax structure are necessary, but need not be made immediately. However, because any legislation that corrects for the consequences of actual economic trends will affect the trust funds' reserves into the distant future, there is both the need and the opportunity for the Congress to consider the entire set of remedies together.

By addressing both the immediate and the longer-run problems now, Congress will also allay anxieties and uncertainties of the public concerning the financial stability of the social security program. Because workers are likely to make contributions for forty years before benefits begin and because social security is the foundation of their retirement plans, public acceptance and support of the program is important. Furthermore, public support may depend upon a better understanding of the system by the 100 million persons who are paying social security taxes and the 31 million persons who receive social security benefits.

My discussion today will focus upon the severity and causes of the solvency problems, both over the next five to ten years as well as over the next 20 to 75 years and how various possible solutions will affect the benefits to different types of individuals. Finally, I will discuss the advantages of considering the remedies to these financing problems together.

I. THE SIZE AND NATURE OF THE FINANCING PROBLEMS

The social security system operates on a pay-as-you-go basis; it does not accumulate large revenues in order to finance future claims. Automatic tax and benefit adjustments were enacted in 1972 to balance receipts and expenditures. This adjustment permits the amount of earnings subject to the payroll tax to rise as average wages rise and the level of benefits to rise as consumer prices increase. These rate and benefit adjustments are expected to keep income and outgo roughly balanced on the average. In years of sustained growth, receipts grow faster than expenditures so as to produce a reserve. This reserve fund is expected to be drawn down in recession years or years when relatively large, rapid price increases occur without commensurate increases in taxable wages.

The tax and benefit adjustments enacted in 1972 would keep the funds in balance, on the average, if two economic assumptions prove correct: (1) that total wages subject to the payroll tax, on the average, increase by 6 percent annually because of increases in employment and current dollar wages, and (2) that prices, on the average, increase at 4 percent annually. Whether or not reserves are depleted depends upon the actual performance of the economy. If total wages increase more slowly, then revenues will be reduced. Also, higher rates of inflation mean higher trust fund outlays.

Between fiscal years 1970 and 1975, the trust funds' reserves increased from \$37.7 billion to \$48.1 billion. However, because the trust funds' outlays increased from \$30.3 billion to \$64.7 billion over the same period, the reserves as a ratio to current year's benefits fell from 125 percent to 75 percent. This substantial decrease in the ratio of reserves to annual benefits occurred as a result of both a short-fall in expected revenues (caused by high unemployment) and an unusually large increase in benefits (caused by rapid price increases).

Past inflation rates increased the base level of benefits, and it is largely because of this that absolute decreases in the funds' reserves can be expected over the next few years. But even this absolute reduction in reserves is not necessarily an indication of insolvency. The purpose of a reserve in a pay-as-you-go system is to cushion short-term financial shocks. Hence, the system is in need of adjustment only if: the financial condition is getting worse and gives no sign of correcting itself; or while capable of correcting itself, it appears to be running out of funds before it can correct itself.

Whether or not either of these conditions will hold over the next few years will be determined by actual performance of the economy. However, there is no question that a depletion of reserves will occur eventually under current policy because of the long-term demographic changes in the population and the legislated increases in benefits.

A separate but very important factor with a strong bearing on the trust funds' deficits over the next five years is the unforeseen and as yet unexplained rise in disability insurance costs. Because disability insurance may require special treatment of both an administrative and structural nature, it is preferable to discuss separately the Old Age and Survivors Insurance fund (OASI) and the Disability Insurance fund (DI).

OASI fund over the next 5 years

The prognosis for OASI over the next five or so years depends upon macro-economic events.

Table 1 compares the 1976 Trustees' Report projection (intermediate assumptions) and the CBO's most recent estimate. The key difference in the assumptions is the higher inflation estimates in the Trustees' Report for fiscal years 1977 through 1979. The effect of this is to provide higher cost-of-living increases to beneficiaries, so that by 1981, the Trustees' estimates of fund disbursements is almost \$4 billion higher (\$108.0 billion versus \$104.3 billion).

As can be seen from Table 1, both sets of projections show a deficit in every fiscal year from 1976 to 1981, although the CBO estimates reserves at the end of fiscal year 1981 of \$31.4 billion, which is about \$7 billion higher than the Trustees', mainly because of the lower rates of inflation assumed. Under both the Trustees' and CBO projections, the reserves at the end of fiscal year 1981 will be less than one-third of the annual benefits paid out.

TABLE 1.—COMPARISON OF TRUSTEES' PROJECTION (INTERMEDIATE ASSUMPTION) AND CBO PROJECTION OF THE PROGRESS OF THE OLD AGE SURVIVORS INSURANCE (OASI) TRUST FUND FOR FISCAL YEARS 1976-81

	1976	TQ	1977	1978	1979	1980	1981
TRUSTEES' PROJECTION (INTERMEDIATE ASSUMPTIONS)							
Economic assumptions (calendar year):							
Annual increase in wages (subject to social security tax).....	\$77	-----	\$8.5	\$9.4	\$8.5	\$7.7	\$6.7
Annual increase in prices.....	\$63	-----	\$6.0	\$6.0	\$5.5	\$5.0	\$4.5
Rate of unemployment.....	7.7	-----	6.9	6.6	6.2	5.7	5.2
Maximum taxable wage.....	\$15,300	-----	\$16,500	\$17,700	\$19,200	\$21,000	\$22,800
Total income.....	\$62.4	\$16.6	\$71.8	\$79.1	\$87.2	\$95.6	\$103.3
Total outgo.....	64.2	17.2	73.4	81.5	89.7	98.7	108.0
Net increase.....	-\$1.8	-\$6	-\$1.6	-\$2.4	-\$2.5	-\$3.1	-\$4.7
Reserve, end of year.....	38.1	37.5	35.9	33.5	31.0	27.9	23.2
CBO PROJECTION							
Economic assumptions (calendar year):							
Annual increase in wages (subject to tax).....	\$7.0	-----	\$8.0	\$8.0	\$8.3	\$8.1	\$8.1
Annual increase in prices.....	\$6.3	-----	\$5.5	\$5.0	\$5.0	\$5.0	\$5.0
Rate of unemployment.....	7.4	-----	6.6	6.6	6.0	5.5	5.0
Maximum taxable wage.....	\$15,300	-----	\$16,500	\$17,700	\$19,200	\$20,700	\$22,500
Total income.....	\$62.5	\$16.7	\$71.7	\$78.7	\$86.4	\$95.1	\$102.9
Total outgo.....	64.4	16.8	73.8	80.3	87.5	95.4	104.3
Net increase.....	-\$1.9	-\$1	-\$2.1	-\$1.6	-\$1.1	-\$3	-\$1.4
Reserve, end of year.....	38.0	37.9	35.8	34.2	33.1	32.8	31.4

¹ The sharp increase in deficit results from a decline in tax rate as 0.1 percent of taxable payroll is shifted from OASI to DI under current law.

What is more disturbing than the continuous depletion of reserves during this period is the lack of a distinct turnaround in the reserve situation. Indeed, under the Trustees' projections, annual deficits appear to be growing larger. In the CBO projections, the annual deficit falls from \$1.1 billion in fiscal year 1979 to \$0.3 billion in fiscal year 1980, but rises again in fiscal year 1981 to \$1.4 billion. This increased deficit in 1981, however, results from the legislated decrease in the OASI tax and not from changed economic assumptions. In 1981, the OASI tax rate drops from 8.7 percent on taxable wages to 8.6 percent. (This tax is shifted to DI.) If this decrease in the OASI tax did not occur, then the projected OASI deficit in fiscal year 1981 would be approximately equal to that of fiscal year 1980.

The continuing strong deficit situation under the Trustees' estimates and the lack of a turnaround under the CBO estimates reflect the economic assumptions used. While the current tax and benefit structure of the social security system is based on a 4 percent increase in inflation and a 6 percent increase in taxable wages, the economic projections used by the Trustees and CBO have utilized higher rates of inflation which, in turn, are inadequately compensated by higher growth rates in taxable wages.

These projections raise questions about whether the automatic adjustments currently built into the social security system are adequate to maintain the solvency of the fund over the next five to ten years. Indeed, the Trustees have shown under pessimistic economic assumptions for inflation and particularly unemployment that the OASI reserves could be exhausted by 1981. Of course, under more optimistic assumptions—that is, lower inflation rates and lower unemployment rates—a rebuilding of the OASI reserves would be projected.

OASI beyond the mid-1980's

If unfavorable economic conditions continue, then revenues could be increased to cover the short-fall in the near future. But small changes in revenues will not solve the deficit problem foreseen for the next 75 years.

The long-range deficit will require much more basic changes. The combined social security payroll tax rate (OASDI) is now 9.9 percent and will rise to 11.9 percent in the year 2011 under current law. In order to keep the funds in balance under current law, tax rates would have to be increased by 75 percent, averaging about 19 percent over the next 75 years. This is principally because of two factors: First, revised demographic projections which show fewer persons of working age compared to the number of social security beneficiaries; and, second, a defect in the automatic adjustments to the benefit formula written into law in 1972, containing an annual adjustment which causes future benefits to grow so rapidly for some groups that they will certainly exceed wages at retirement. The seriousness of this problem was first brought to public attention in the 1975 Trustee's Report.

The demographic shift.—Knowledge that those born during the postwar baby boom of 1947 to 1954 would be retiring in about 2012 to 2020 has long been built into the long-range projections. However, the continuation of the decline in the fertility rate following the baby boom and the depth of the decline have only recently been accepted as actuarial assumptions. These changes in fertility rates would bring about the lowest ratio of working age population to retired population that the system has ever experienced. The ration will shift from 30 beneficiaries per 100 workers in 1975 to 50 beneficiaries per 100 workers in 2030. To fund the additional beneficiaries with the smaller ratio of taxpayers would require an increase of about 20 percent over scheduled tax rates for each worker.

The second factor is the benefit computation formula. It is worthwhile taking a closer look at the formula and its defect because major proposals to revise the formula are about to be presented to the Congress.

The social security benefit computation formula is simply an equation to determine how much of the earnings that were lost by retirement, death, or disability will be replaced by the benefit. The summary equation is: Average lifetime wages times wage replacement factor¹ equals benefit amount.

Under the statutory changes made in 1972, whenever benefits for those already on the rolls are increased to keep pace with the cost of living, the wage replacement factor is also increased by the same percentage. This was established to assure that every future retiree who had the same average lifetime wage as a current retiree could receive the same benefit. This adjustment or indexing overlooked the fact that average lifetime wages of the future retiree are also rising and, therefore, the benefit formula is actually overadjusted. Chart 1 illustrates this problem.

Until about 1995, this overadjustment compensates for a different adverse phenomena: the lengthening of the period over which wages are averaged. In 1950, the Social Security Act was amended so that the averaging period would include only those years since 1950. This means that until 1995, when the period stabilizes at 45 years, the averaging period will increase and therefore the average lifetime wage and the related benefit level would become smaller as a percentage of final wages.

As a result, simply eliminating the indexing of the wage replacement factor (commonly known as "decoupling") would, if no other adjustment is provided, decrease the ratio of retirement benefits to final wages.

¹ The wage replacement factor is the percent of average monthly wage to be replaced by benefits. It is not a single value. It is graduated into different values over dollar-range brackets so that persons with lower wages get a higher percentage of their former earnings replaced.

HOW THE "COUPLED" BENEFIT FORMULA OVERADJUSTS THE OASDI PROGRAM FOR INFLATION

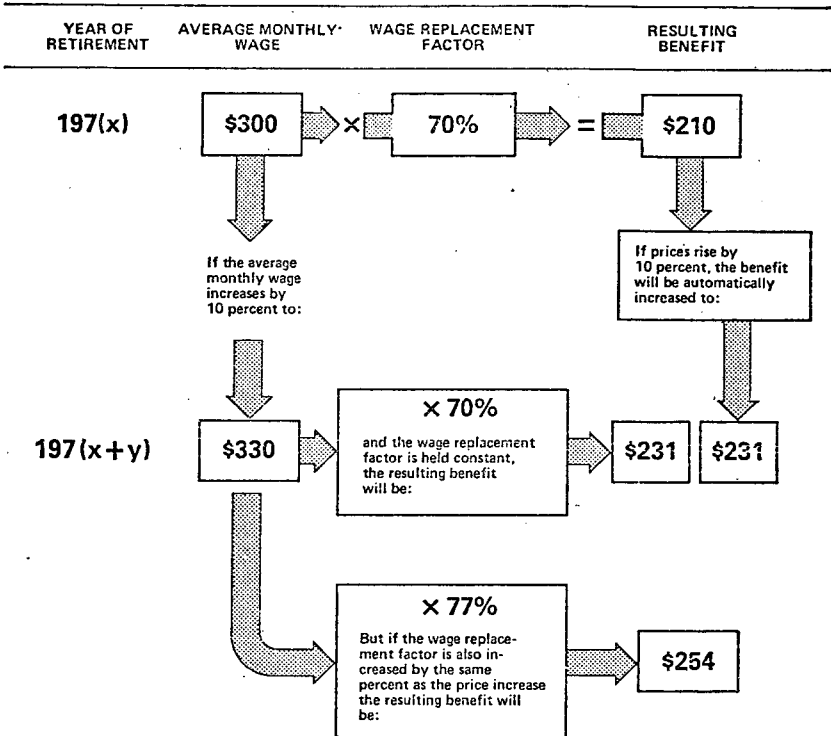


CHART 1

Disability insurance

The disability insurance (DI) trust fund is in dire condition for reasons that go beyond those affecting the OASI fund. The DI fund is sensitive to the same economic changes as the OASI fund, and in fact more so to unemployment (because disabled workers are more vulnerable to loss of employment). However, a greater problem for this program is the continued and as yet unexplained increase in the number of beneficiaries. Since 1965, the number of new beneficiaries has risen sharply and the rate at which persons are leaving the benefit rolls has fallen sharply. As a result, the actuaries have revised their estimates of normal costs for this system six times since 1965.

Both the Trustees and CBO projections indicate (as shown in Table 2) that the DI fund reserve would be exhausted by fiscal year 1979. If special authority were to be enacted to allow funds to be shifted from the OASI to the DI trust fund, the combined fund reserves would be decreased by the rapidly increasing DI annual deficits. Without structural changes, the DI program would accumulate total deficits by fiscal year 1981 of \$7.2 billion and \$15.7 billion under the Trustees' and the CBO estimates respectively.

The difference between the Trustees estimates and the CBO estimates reflects different judgments as to whether the rate of new benefits will begin to stabilize. CBO has no basis to assume that the current rates will level off. They may, in fact, but the estimates can only reflect the current knowledge of probabilities. In any case, it is clear that some strong action will have to be taken before 1981 and that the action may include revision of both administration and structure of the fund.

TABLE 2.—COMPARISON OF TRUSTEES' PROJECTION (INTERMEDIATE ASSUMPTION) AND CBO PROJECTION OF THE PROGRESS OF THE DISABILITY INSURANCE (DI) TRUST FUND FOR FISCAL YEARS 1976-81

	1976.	TQ	1977	1978	1979	1980	1981
TRUSTEES' PROJECTION (INTERMEDIATE ASSUMPTIONS)							
Total income.....	8.4	2.2	9.5	10.7	11.8	12.8	14.6
Total outgo.....	9.6	2.7	11.3	12.9	14.5	16.4	18.3
Net increase.....	-1.2	-.5	-1.8	-2.2	-2.7	-3.6	-3.7
Reserve, end of year.....	7.0	6.5	4.7	2.5	1-2	1-3.8	1-7.2
CBO PROJECTION							
Total income.....	8.3	2.2	9.4	10.6	11.6	12.7	14.5
Total outgo.....	9.6	2.7	11.9	13.9	16.4	18.0	20.7
Net increase.....	-1.3	-.5	-2.5	-3.3	-4.8	-5.3	-6.2
Reserve, end of year.....	6.9	6.4	3.9	.6	1-4.2	1-9.5	1-15.7

¹ Fund has no authority to go into a negative balance. These figures are demonstrative of what would happen if the fund were to borrow at prevailing interest rates.

In light of the fundamental differences in the nature of the OASI and DI problems, there would seem to be a very strong argument to treat the DI program separately with regard to remedies.

The House Ways and Means Committee is undertaking an intensive study of the program. There is some concern that the unpredictable increase may be due to:

- (a) Liberalization of the law;
- (b) A greater awareness of the program and a consequent larger application rate;
- (c) The accelerated increase in the administrative burden on the Social Security Administration through the assignment of the Black Lung and SSI programs which may have caused a deterioration in the quality of program operations; and
- (d) The increase in judgmental factors in the determination of disability.

Combined OASDI trust fund reserves

The OASI fund is likely to have between \$23 billion and \$31 billion in reserves by 1981, and the combined reserves of OASI and DI trust funds could be between \$15 and \$16 billion. Even at this level of reserves, it would appear that the combined trust fund revenues will be adequate for the next several years under all but the most pessimistic assumptions. However, if the annual deficit in DI continues at a rate of \$4 to \$6 billion, then the combined OASDI trust fund reserves could be depleted within a few years.

While such a prognosis does not necessarily warrant action this year or next, it is likely that steps will have to be taken within the next five years, if for no other reason than to correct for the deficiency in the DI fund. Congress could wait five years or more to determine how the long-term solvency problems should be handled. However, this might unnecessarily heighten public concern, particularly for those who depend on social security for retirement income.

II. POSSIBLE REMEDIES

A. Immediate proposals

One option before the Congress is the President's proposal contained in the fiscal year 1977 budget.—The proposal would increase the OASDI payroll tax by 0.3 percent of earnings subject to tax for both employer and employee and institute certain long-range reductions in benefit eligibility. The new tax rate would raise the current combined rate of 9.9 percent to 10.5 percent and would maintain a large positive balance in the combined OASI and DI funds through 1982. This proposal presumes that:

Before the funds are depleted, Congress will take the next step of revising the benefit structure to correct for the overadjustment in future benefits, and

Afterward, Congress may, with less pressure, correct the remaining deficit over the long term.

Some may object to this approach, not only because of a disagreement about the need for action in this session, but because of the nature of the immediate action. An increase in the tax rate aggravates the regressive nature of the payroll tax and could increase inflationary pressures in the short run.

As an alternative, tax revenue can be increased, still within the payroll tax structure, by increasing the amount of earnings subject to tax. This would shift the additional burden to higher wage earners. The affected wage earners would not be paying a greater tax rate on their total wages than would persons with lower wages. However, a wage base increase is less efficient than a tax rate increase because it would create entitlement to higher benefits in the future. In fact, under the current program structure, these future benefit costs would actually increase the long-range deficit.

If immediate corrective action is deemed to be necessary, there are at least two other approaches besides revenue increases under the payroll tax structure that could provide temporary relief until permanent remedies are selected.

1. *Provide a grant from general revenues.*—The amount needed, if no other remedies were adopted before 1981, would range from zero under the most optimistic economic assumptions to \$13 billion under the Trustees' most pessimistic assumptions.

2. *Emergency borrowing authority from the general fund.*—Congress could provide a limited authorization to cover temporary deficits by borrowing from the U.S. Treasury. Unlike an outright grant, it would permit the system to retain its self-financing structure while at the same time avoiding long-term measures to correct short-term crises. Provisions of this type have been enacted in the past but have never been used. This alternative assumes annual surpluses in the future large enough to repay the loans.

B. Structural reforms

Structural changes in the system include higher levels of revenues or lower levels of benefits. The higher levels of revenues may be achieved either by increasing the payroll tax or by some support from general revenues. The lower levels of benefits may be achieved either by a general reduction in benefit levels (lowering the ratio of benefits to final wages) or by selective reductions in eligibility and entitlement (reducing the progressive nature of the benefit shifting some dependency and survivor benefits to other programs). The magnitude of the structural changes in revenues or benefits depends upon the extent to which revised economic assumptions differ from those now used in the social security system.

1. Higher levels of revenues

Increases in payroll tax.—If the entire deficit were to be remedied by a one-time increase in the payroll tax rate, it would require an increase of 6 percent of taxable payroll in the OASI fund (63 percent higher than the current rate) and 2 percent of taxable payroll in the DI funds (128 percent higher than the current rate). These increases would have to be put in place at once.

If tax rates were increased annually by only enough to meet current costs, the tax rate for OASI would have to be 23.7 percent of taxable payroll in the year 2050 (119 percent over the rate currently scheduled for that year) and for DI it would have to be 4.87 percent (or 286 percent over the rate currently scheduled for that year). Table 3 summarizes these tax increases on annual and one-time adjustment bases.

TABLE 3.—CURRENT AND NECESSARY TAX RATES AS A PERCENT OF TAXABLE PAYROLL¹

Annual adjustment	Tax rates in current law			Necessary revisions		
	OASI	DI	Total	OASI	DI	Total
Calendar year:						
1975.....	8.75	1.15	9.90	9.29	1.36	10.65
2050.....	10.2	1.7	11.9	23.72	4.87	28.59
1-time adjustment.....	9.43	1.54	10.97	15.42	3.51	18.93

¹ 1976 trustees report—intermediate assumptions.

Under an immediate or one-time increase, the fund would build up a huge surplus in the early years. With annual increases, the combined tax rate would have to be almost 29 percent of covered wages, a rate which would be intolerable.

Support from general revenues.—There has long been controversy about the priority of adding revenues to the system from general revenues. Those who argue against it defend their position mainly on the need to preserve the integrity of the self-financing system. Those who argue for general revenue support defend their position mainly on the basis that a very large part of the benefit commitment is not entirely wage-related, but also includes income redistribution from the richer to the poorer participants. Under these circumstances, it is said to be inequitable to support such transfers of income with funds raised by regressive taxes, particularly when higher incomes derived from sources other than wages are not taxed.

2. Lower levels of benefits

General benefit reductions.—Most proposals for correcting the benefit computation formula would eliminate the indexing of the wage replacement factor (the relationship of benefits to average wages) and replace it by indexing the earnings history. "Indexing" earnings history translates each past year's earnings into current year's values by multiplying the past year's earnings by the growth that has taken place in some other economic factor.

The two most popular alternatives for indexing earnings history are to index by (a) wages or (b) prices. The differences between them may become an important issue.

The Social Security Advisory Council of 1975 suggested wage-indexing the earnings history in order to stabilize the current relationship between benefits and final wages. All prior year wages would have the same comparative value as wages earned in the year before retirement. This approach would eliminate half the deficit.

Earnings history could also be indexed by price. Since prices over a long period of time do not grow as rapidly as wages, the relationship of benefits to final wages would decline continuously over time. Therefore, all other things being equal, price-indexing develops more savings. It could be employed to eliminate the entire deficit by itself. One should recognize, however, that this would be tantamount to an across-the-board reduction in benefit commitments for future retirees. This is the exact situation that many fear: Although taxes will remain high, future social security benefits as a percentage of final wages will be reduced.

The advantage of wage indexing is that it preserves the relative level of benefits with regard to current wages for all future beneficiaries. However, it produces less savings than price indexing.

The advantage of price indexing is that it produces more savings for the system. However, it does this by sustaining a high level of payroll taxes while reducing the relative level of benefits.

Those who argue for price-indexing contend that adjustments can be made later by future Congresses whenever they believe that to be necessary. Funds would have to be found at that time to finance any increases. These increases could be offset by other benefit reductions.

Earnings history is not the only element in the formula that can be indexed. In addition to, or instead of, earnings history, the dollar range of the brackets to which the wage replacement factors are applied can be indexed. Alternatively, other types of adjustments are possible, such as changing the length of the period over which earnings are averaged or the number of years that can be dropped out in calculating the average wage.

It is a crucial but not well understood point that while indexes and values of all the elements of the formula can be combined in a number of ways to produce many different results, each change in the valuation of any element in the formula will affect different groups of individuals differently. For example, workers whose earnings rise more slowly or end earlier in life than the average worker will be gainers in a formula that indexes earnings history (because it will increase the value of earnings earlier in life). About 12 percent of the population fall into this group. Wage indexing can increase the effective or countable average lifetime earnings of workers by as much as 50 percent; price indexing by as much as 25 percent. Increasing the number of years excluded from the period over which wages are averaged will benefit workers who move in and out of covered employment or whose earnings are highly variable.

Specific reductions in benefits.—Except for those changes in the benefit computation formula which would involve drastic future reductions in benefits as a percentage of final wages, indexing benefits will eliminate only about half of the long-term deficit. Other options to reduce benefits for more narrowly targeted groups should be considered.

For example, a large part of the costs under this system consists of income transfers from high-wage earners to the low-wage earners, or to the dependents of retired workers. The degree to which these transfers occur and are desirable in this system rather than in other public assistance systems is worth considering because: (1) social security is an inefficient system for delivering as assistance to the poor; it uses average lifetime earnings as the criterion for current need, providing costly windfalls to some nonneedy; (2) particularly when the system is in serious deficiency, it may be appropriate to shift the financing of nonwage-related benefits to other programs, paid out of general progressive taxes, rather than to finance these benefits from the regressive payroll tax; and (3) there may never be a better opportunity than now, when there is a visible need to reduce costs, to reexamine the depth of involvement of this system in providing minimum income to all social security beneficiaries.

While it is possible to consider the structural proposals separately, this should not be done. They interact with respect to which individuals would be affected and by how much; with other income transfer programs; and with some of the immediate actions being proposed.

SUMMARY

1. While it does not seem to be necessary to act immediately to avoid undue risk to the short-term status of the fund, action is likely to be needed within five years.

2. It is desirable to consider measures that could be taken immediately in terms of their interaction with permanent structural changes.

3. Changes in the benefit computation formula, while necessary, are probably not sufficient to solve the long-term deficit.

4. There is time to consider other major permanent changes of a structural nature which, together with changes in the benefit computation formula, would be sufficient to restore long-term financial stability to the program.

5. This may be the most appropriate time for the Congress to think through a complete set of changes which would be adequate to solve the total financial problem while improving the equity of this important program.

Representative BOLLING. Thank you.

Next we will hear from Chancellor Wallis.

He has a time problem so I think at the conclusion of his statement, I will look at the time and decide whether to open up for questions to him and then proceed with the other panel members.

Please proceed, sir.

STATEMENT OF W. ALLEN WALLIS, CHANCELLOR, UNIVERSITY OF ROCHESTER AND CHAIRMAN OF THE 1975 ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. WALLIS. Thank you, Mr. Chairman. Although I had the honor of being chairman of the Quadrennial Advisory Council on Social Security that reported, pursuant to section 706(d) of the Social Security Act, in March 1975, I cannot by any stretch of the imagination present myself as an expert on social security. While the Council was working, beginning in May 1974, I became acquainted with some aspects of the system, but because the Council had only 8 months for its work instead of the 2 years contemplated in the law, it limited its attention to a few of the subjects deemed most important.

Besides that limitation, social security is such a large and complex subject that only someone living with it every day can hope to keep a firm grasp even of topics once mastered.

To this statement I will append the three page "Summary of Major Findings and Recommendations" from the Advisory Council's Reports, and I will confine myself today to three points that seem to me especially important and urgent.

Representative BOLLING. The full summary will be included.

Mr. WALLIS. The three points on each of which I will expand are:

(1) The soundness of the system, and consequently the answer to the often asked question, Will I get my benefits when I retire? depends entirely on the future willingness and ability of the Congress to appropriate the benefits and raise the money for them, and has nothing to do with what people pay in before retirement and almost nothing to do with the trust funds.

(2) Because of a serious error in the cost of living adjustment to benefits, Congress has lost control of the level of benefits, so that no one can tell what they will be in the future, and correction of this error is urgent and fairly simple.

(3) Extensive research on many fundamental issues related to social security should be carried out soon to provide a sounder basis for future advisory councils and for Congress than is available now, since otherwise the councils and Congress can only continue to recommend minor adjustments and patches on what has already become too much of a patchwork quilt and may even become a crazy quilt.

I will try to explain each of these three points.

1. PAY AS YOU GO

Many people think that the social security taxes taken out of their wages and sent to Washington each month provide for their old-age pensions and other social security benefits. This simply is not the case. Those taxes are levied on workers in order to pay benefits to people who already have retired and are drawing their social security pensions, or to pay other social security benefits to those who already are drawing them. Just as Federal gasoline taxes are special taxes earmarked to pay for certain services, social security taxes are earmarked to pay for certain welfare expenditures. When you pay social security taxes you are in no way making provision for your own retirement. You are paying the pensions of those who already are retired.

Once you understand this, you see that whether you will get the benefits you are counting on when you retire depends on whether the Congress will levy enough taxes, borrow enough, or print enough money, and whether it will authorize the level of benefits you are counting on.

The situation is in no way analogous to putting money each month into a private insurance company which invests it and undertakes to pay you an annuity. In that case it is sensible to ask, Will the company be sound enough to pay what they promised? In the case of social security the only sensible questions are political, Will Congress continue to authorize and fund the benefits?

I am not a politician or a political scientist, but the answer to that political question seems to me obviously and certainly yes. But don't think you will get your benefits because you "have been paying for them all these years"; because you haven't. What you paid in the morning went out that afternoon to someone already retired.

Sometimes people suggest that this pay-as-you-go system in social security is not much different from what a private insurance company does. A private insurance company ordinarily pays benefits due in a given month from premiums received that month. But there is a very basic difference. Social security taxes are set at rates intended to balance the total receipts with the total outgo over periods of a few years. Private insurance companies set rates for annuities as if they were maintaining a separate fund for each person, into which his premiums would be paid, to which interest would be credited, and from which benefits would be paid, with life insurance policies to adjust for differences among individuals in length of life.

Misunderstanding of the pay-as-you-go nature of social security is widespread among journalists and the public. Indeed, this misunderstanding seems to have been deliberately cultivated sometimes, in the belief that it makes the social security system more palatable to the public.

2. DECOUPLING

The Advisory Council was unanimous in recommending what is called "decoupling," the correction of a technical error in the automatic cost-of-living adjustment that was introduced in 1972.

Unfortunately the error is technical and hard to understand. If it were obvious, presumably it would not have occurred in the first place. But I will try my hand at explaining it.

First, a fact about the way benefits are determined when a person retires: His average monthly earnings are calculated, and there is a table in the law showing what the monthly benefits will be for any value of average monthly earnings. There are some complications about calculating average monthly earnings, but none of them make any difference for understanding decoupling. Benefits are higher, the higher the average monthly earnings.

Now the way the automatic cost-of-living adjustment is made is to raise the schedule of benefits when the Consumer Price Index rises, so that at each value of average monthly earnings the benefits are increased by an appropriate percentage.

If a person had average monthly earnings of, for example, \$400, earned before inflation, his retirement benefit according to the benefit table in use a couple of years ago would be \$260 per month. Then if there is a 10-percent inflation the benefit should go up by \$26 to \$286. So far, so good.

But now consider a person with the same job history, except that he worked after inflation of 10 percent. His average monthly earnings will be \$440. That increase of \$40 in his average monthly earnings will bring him an increase in benefits, even without a cost-of-living adjustment. Under the benefit table in use a couple of years ago it would bring him about \$16 a month more, or \$276. So the increase in wages that inflation causes would, at least to a first approximation, bring about an automatic increase in benefits even if the benefit sched-

ules were not adjusted. But because of the 1972 automatic adjustment of the benefit schedule, a further upward adjustment of about 10 percent occurs, and the benefit becomes about \$304. Thus when there is 10 percent inflation, benefits go up from \$260 to \$304, or by 17 percent. The monthly benefit after inflation is 69 percent of the average monthly earnings instead of the 65 percent that Congress established before inflation.

This kind of example, where the benefits go up substantially more than the cost of living, has led some to refer to the error as "over-indexing." It should be noticed, however, that under some circumstances the results of the error could be under indexing. The benefits might fail to go up enough to give retired workers as high a percentage of preretirement earnings as Congress intended. For example, if wages were to rise 5 percent per year and the Consumer Price Index at 2 percent per year, then a worker with low earnings who in 1975 would have retired with benefits 61 percent as much as his preretirement earnings, would, if retiring in 1985, receive only 55 percent and in 2000 only 51 percent of preretirement earnings. There are other examples in the 1974 Advisory Council's report.

Thus, the point is not overindexing or underindexing but loss of control by Congress over what relation benefits will have to final earnings. Under the conditions now expected during the rest of this century, it seems likely that the error will result in overindexing. In fact, of the 8-percent longrun deficit estimated in the trustees' report earlier this week, almost half is due to anticipated overindexing.

The Advisory Council recommended a straightforward way to remedy this serious error. The way to do it is to index monthly wages before they are averaged.

For example, suppose a worker retires in May 1986. What he actually earned in, say, November 1955 would be indexed by increasing it by the same percentage that average wages in May 1986 are above average wages in November 1955. Similarly his actual earnings for every other month would be indexed to a May 1986 equivalent. Then these indexed monthly earnings would be averaged. A new benefit table would be constructed relating benefits to average monthly indexed earnings instead of to average monthly actual earnings. This table could produce replacement ratios fairly close to what Congress intended before it lost control. After retirement benefits would increase according to the Consumer Price Index.

The use of average monthly indexed earnings would, as the reports of the advisory council point out, make possible a number of simplifications and improvements in the benefit schedules.

There has already been too much delay in correcting this serious technical error. It, more than any other single factor, threatens the integrity and stability of the entire social security system. If it is not corrected promptly, vested interests will grow up around the artificially inflated benefits and will make correction politically difficult.

3. RESEARCH

On this subject I take the liberty of repeating part of the testimony that I gave in May 1975 before the Social Security Subcommittee of the House Ways and Means Committee.

As a foundation for the next council's work there should be a comprehensive study by a non-Government body of such fundamental issues as full reserve funding, versus current cost financing; the effects of social security on productivity, capital formation, and private savings; the relationship between private pensions and social security; the appropriate size of the trust funds, and other basic issues.

No council of this kind can carry out that type of research. Indeed, research is not properly a function of such a council. Instead a council ought to be able to draw, to the extent that it finds appropriate, on a body of research relevant to the policy issues with which councils should deal.

Another reason for such a study is that the social security system has never, so far as I know, been subjected to a totally independent, detailed scrutiny of all of its actuarial, statistical, and technical assumptions and procedures. The trustees' reports and the reports of advisory councils have relied ultimately on the data and analyses of present or former members of the social security staff. No one else is competent enough, and the trustees and councils do not have enough time for completely fresh people to develop competence comparable with that of those who have had long experience with social security.

This is not to impugn in the slightest the competence, integrity, and dedication of the social security staff. On the contrary, the council had the highest respect for, confidence in, and even admiration for the staff. But a review or audit needs to be independent, for truly independent reviews and audits have a value that simply cannot be attained without total independence.

In the next few years Congress and the public will focus more attention on social security than it has ever received before. It is important that completely independent evaluations and analyses be available, and this is by no stretch of the imagination a reflection on the present small group of social security experts. In addition, many basic issues should be studied that are outside the scope and competence of the Social Security Administration. The system is now 40 years old, and personally, I attach great urgency to an independent, detailed, thorough, objective, non-Governmental review. Every effort should be made to have it completed in time for the 1978 advisory council to use its findings.

Thank you.

[The summary referred to follows:]

[From Reports of the Quadrennial Advisory Council on Social Security, 94th Cong., 1st sess., H. Doc. 94-75]

SUMMARY OF MAJOR FINDINGS AND RECOMMENDATIONS¹

A. CASH BENEFITS

1. *Purpose and principles*

The earnings-related OASDI program should remain the Nation's primary means of providing economic security in the event of retirement, death, or disability. It should be supplemented by effective private pensions, individual insurance, savings, and other investments; and it should be undergirded by

¹ The Council's findings and recommendations reflect a consensus of the Council and not necessarily the precise view of any individual member on any issue. To the extent that Council members have chosen to express their differences from the Council's findings and recommendations, such expressions are contained in the section of statements at the end of the report. Footnotes at appropriate points in the body of the report call attention to these supplementary statements.

effective means-tested programs. Future changes in OASDI should conform to the fundamental principles of the program: universal compulsory coverage, earnings-related benefits paid without a test of need, and contributions toward the cost of the program from covered workers and employers.

2. *Benefit structure—Replacement rates*

The provisions of present law for computing average monthly earnings, on which benefits are based, and for adjusting the benefit table in the law to changes in prices may result over the long range in unintended, unpredictable, and undesirable variations in the level of benefits. The benefit structure should be revised to maintain the levels of benefits in relation to preretirement earnings levels that now prevail. Benefits for workers coming on the rolls in the future should be computed on the basis of a revised benefit formula using past earnings indexed to take account of changes during their working lives in the average earnings of all covered workers. As under present law, benefits for people on the rolls should continue to be increased as price levels increase.

3. *Retirement test*

The provisions of the present retirement test should be modified so that beneficiaries who work can retain more of their benefits. Instead of reducing benefits by one dollar or every two dollars of earnings above the exempt amount of earnings, as under present law, one dollar of benefits should be withheld for every three dollars of earnings between the exempt amount and twice the exempt amount, and one dollar for two dollars above that level. Also, the provision under which a full benefit may be paid for any month in which a beneficiary earns less than one-twelfth of the annual exempt amount should be eliminated, except for the first year of entitlement to benefits. The test should be based on annual earnings.

4. *Treatment of men and women*

The requirements for entitlement to dependents' and survivors' benefits that apply to women should apply equally to men; that is, benefits should be provided for fathers and divorced men as they are for mothers and divorced women and benefits for husbands and widowers should be provided without a support test as are benefits for wives and widows. At the same time, the law should be changed, effective prospectively, so that pensions, based on a person's work in employment not covered by social security will be subtracted from his social security dependents' benefits. Other provisions of the social security program which are the same for men and women but which are criticized because they appear to have different average effects on men and women (or different average effects on the married and the unmarried) should not be changed.

5. *Other recommendations*

(a) *Universal compulsory coverage.*—Although social security covers over 90 percent of workers, the gaps that remain often result in unwarranted duplication of benefits. Social security coverage should be applicable to all gainful employment. Ways should be developed to extend coverage immediately to those kinds of employment, especially public employment, for which coordinated coverage under social security and existing staff-retirement systems would assure that total benefits are reasonably related to a worker's lifetime earnings and contributions.

(b) *Minimum benefit.*—Partly because of the gaps in social security coverage, the minimum benefit is frequently a "windfall" to those, such as Federal retirees, who are already receiving a pension based on earnings in employment not covered by social security. Almost all workers who have worked in social security employment with some regularity become entitled to higher than minimum social security benefits. The minimum benefit in present law should be frozen at its level at the time the new benefit structure recommended under number 2 above goes into effect and the new system should not pay benefits exceeding 100 percent of the indexed earnings on which the benefit is based.

(c) *Definition of disability.*—The definition of disability should be revised to provide disability benefits for workers aged 55 or over who cannot qualify for benefits under present law but who are so disabled that they can no longer perform jobs for which they have considerable regular experience. These benefits should be 80 percent of the benefits for those disabled workers who qualify under the present law.

(d) *Miscellaneous*.—Further study is needed on three matters; the effects of the social security program on different racial and ethnic groups, ways of simplifying the social security program and its administration, and the frequency of cost-of-living adjustments in benefits. In addition, a general study of social security should be made by a full-time non-Government body, covering such matters as funding vs. pay-as-you-go, possible effects of social security on capital formation, productivity, the proper size of the trust funds, the incidence of payroll taxes, and other basic questions.

B. FINANCING

1. Actuarial status

The cash benefits program needs a comparatively small amount of additional financing immediately in order to maintain the trust funds levels. Beginning about 30 years from now, in 2005, the program faces serious deficits. Steps should be taken soon to assure the financial integrity and long-range financial soundness of the program.

2. Tax rates

(a) *Employee-employer*.—No increase should be made, beyond those already scheduled in present law, in the total tax rates for employees and employers for cash benefits and hospital insurance. However, the OASDI tax rate should be gradually increased, as OASDI costs increase, and the increases should be met by reallocating taxes now scheduled in the law for part A (hospital insurance) of the Medicare program. Income lost to the hospital insurance program by this reallocation should be made up from the general funds of the Treasury. Hospital insurance benefits are not related to earnings, so should be phased out of support from the payroll tax.

(b) *Self-employed*.—The present 7-percent limitation on the tax rate for the self-employed should be removed. The self-employment OASDI tax rate should be the same multiple of the employee contribution rate as was fixed at the time the self-employed were first covered—150 percent.

3. Retirement age

The Council recognizes that under current demographic projections there will be a sharp rise in the number of people who will have reached retirement age relative to the working age population in the first several decades of the next century. Although the Council is not recommending an increase in the age of eligibility for social security retirement benefits, the Council does believe that such a change might merit consideration in the next century, when the financial burden of social security taxes on people still working may become excessive.

Representative BOLLING. Thank you for a comprehensive statement, Chancellor Wallis.

According to the Treasury Department, the revenue loss resulting from the tax advantage of private pension funds is more than \$4 billion annually.

Since there is a growing feeling private pension plans are integrated with social security, about 10 percent of these plans tend to disadvantage the low or moderate income worker. Should future legislation carry out the intention of social security by making benefits more equitable to those on the lower end of the integrated scale?

Mr. WALLIS. I am not sure I understand the question.

Representative BOLLING. Do you think that in the integrated aspect of social security, do you think there should be some consideration given to the tax cost of the private—the tax cost to the public generally of the private plans?

There is a very substantial tax benefit given, I suppose, to encourage private insurance plans, private retirement plans which turns out to be about \$4 billion, according to the Treasury.

Then you have the question of integrating social security with private plans and my information is that 60 percent of private plans

are so integrated. The question there is from an overall point of view, should there be some consideration given to transfer from the better off to the less well-off in compensation for the \$4 billion a year that it costs to encourage the private plan aspect of it?

Mr. WALLIS. Let me say two things about that. First, the general philosophy of the social security system from the beginning, 1935, has been that there should be three levels of provision for retirement. The middle lead would be social security which would provide a minimum necessary amount of retirement income. Since social security is, however, wage-related, there would be some people who would not qualify for enough social security benefits and therefore welfare programs would be needed underneath social security. Finally, private savings should be encouraged for additional retirement income above the bare minimum provided by social security.

So what you are referring to as a cost in terms of the \$4 billion figure you cited—I have no idea how they figured that one out but it does not matter—what you are referring to there as a cost could be regarded as a fee that is paid for a service rendered by private pension plans to the extent that the private pension plans relieve public funds, and make it unnecessary for social security to provide more than a minimum retirement income.

At any rate, I think that there ought to be room for private plans. Whether they should be subsidized by special incentives, I don't know. My impression is that the subsidies to private plans come largely through deferring the tax on income set aside for retirement until the retirement income is drawn.

Representative BOLLING. Recently the Congress began insisting that there be an attempt to determine the cost of provisions in the tax code that were beneficial to individuals, groups and interests and the tendency has apparently become a habit.

We are now looking by law through the Budget Act and a variety of other things at the actual cost of tax benefits and the techniques for translating them are relatively simple.

If you get special tax treatment, then presumably it saves a certain amount of money and you can translate that into a loss to the general fund and a benefit to the individual. The question that I am raising, really, is should that not be taken into account when one devises the social security system when one restudies the social security system in relation not only to the system itself but also to the other facets and aspects of its relationship to other systems?

That is, private systems? Which leads me to my general question which is, what do the other members of the panel—although Mrs. Rivlin has had an opportunity to testify—think of the notion that we need a general fund study?

Next, if we do need a general independent study outside of the Congress and outside of the executive, what should it include and should it not surely include the kind of questions—the background of the kind of question that I have just raised?

What are we talking about? Are we talking about a study of the social security system or are we talking about a study of the income maintenance system of the United States?

Mr. WALLIS. I think the questions you have raised would be included in this, and also much broader questions. What is the effect on the level

of the national income, on capital formation, on savings, and so on. There are many pervasive effects of a system like social security. It may be that when Congress introduced incentives for people to save on their own for additional retirement income beyond social security they may have felt also that the accumulation of capital was beneficial nationally in terms of raising productivity.

Representative BOLLING. Maybe that is true.

All kinds of arguments were made for the original Keogh proposal and the ones that came later. It was a very interesting exercise.

Mr. WALLIS. Let me make one other comment on your question about coordination. An integrated system has a fair amount of appeal. It seems sensible. My inclination would be, however, that Congress ought to stay out of that because Congress is coming to regulate every activity of everybody in too much detail. There is little you can do in the United States today but what you find yourself tangled with Government regulations, Government officials right and left, enormous amounts of redtape and paperwork.

You cannot have an integrated system like that without Congress getting involved in regulating private pension plans even further than they have with ERISA. I think that the integration that has come about so far has come about by the private plans saying we will provide for what social security does not. The people decide what they want in the aggregate. They look to see what Congress has provided through social security and arrange to provide whatever supplements they think appropriate. What supplements are appropriate may differ greatly in different circumstances.

Representative BOLLING. Well, the dilemma that I have in that answer, Chancellor Wallis, is that I happen to be one of the very few people in the house that voted against whatever its name was, the proposal on the pension plan the first time through, the proposal for extensive supervision.

I did so because I could recognize what I thought was an illegitimate relationship made legitimate by laws. The managers of the great union programs were anxious to get certain things passed and the proponents of the Kehoe approach were interested in getting certain things passed.

Their interests were in conflict. They made an alliance in order to get a certain kind of legislation passed for each. I perceive that it made no sense at all that we passed the legislation at the time that we did, although it was overdue.

It seems to me that the question—maybe it is not pertinent but it seems to me it is tied in. What should we be looking at?

If we should have an independent, overall approach on the outside of Government, what kind of a group should we put together and what should we be looking at? Is it as narrow as social security? Is it the whole question of income maintenance? Is it the whole question of income maintenance and a variety of the other things which are related, for example, the welfare system?

The question of health insurance? I am not trying to get this completely out of bounds.

Mr. WALLIS. I think your question is a good one. In research of this sort, one thing leads to another. That is one of the reasons I think it

would be better set up through a private research agency. I have in mind an organization such as the National Bureau of Economic Research.

This isn't the kind of thing they have ever done, so maybe they wouldn't do it. But it is the organization that has done the basic research on which most of our data about the economy depends. They developed concepts on gross national product, productivity, cyclical indicators, and so forth.

The person doing the most along these lines today is Mr. Feldstein here, so I would suspect he could expand a long time on what kind of research should be done under a program of this sort.

Representative BOLLING. We are talking about very broad issues but I have to reveal my prejudice as one of the people involved in the creation of the budget account. It would seem to me that although I know that the CBO has plenty of things to do and the budget committees have plenty of things to do, that one of the functions of governmental institutions dealing with the overall problems might well be to either provide for that study or undertake it.

It seems to me it is going to be more than the study of a year or so.

Mrs. RIVLIN. If I may jump in on this, it seems to me it should be a broad study and that was the purport of my testimony. I think it would be a mistake for the Congress to get too focused on what may or may not be a shortrun problem of reserves that requires action.

It may require some action but to focus only on that and not look at the long run structure of the social security system would be a mistake. It would seem to me that a study or studies—and it probably is not a good thing to turn it over to one group be they inside or outside the Government—should focus on the general subject of what does the United States want to do about retirement and survivors' disability provisions and how we want to pay for it.

This would encompass the relationship of the social security system to benefits provided through the tax system. That seems to be a very valid set of considerations, just as it is in health insurance.

We provide a subsidy to private health insurance and that has to be thought of along with Government outlays as one of the things the Government does in this area. Similarly in retirement insurance. There is a question of the relationship between social security and other forms of income maintenance which should be considered.

I think looking at the whole ball of wax, a study of everything that the Government does for people, is rather hopeless as a single study. I would suggest that the area of concern now be confined to the consideration of what to do about retirement survivors and disability benefits—but in a larger context.

Mr. FELDSTEIN. I am certainly very sympathetic with what Mrs. Rivlin has said, both to the narrowing of it to deal with the survivors and disabled, the extension to deal with how that is done in the private sector and the use of multiple studies rather than a single contractor to do it.

I don't think one has to go all the way to a single contract to something like the National Bureau to achieve this kind of independence. This document is a preliminary copy of a report done for the Ways and Means Committee, and the Senate Finance Committee, on a rather

narrow set of financing and benefit issues by an outside panel through the Congressional Research Service.

The same thing could be done in other aspects of the problem by turning also to Brookings, the Rand Corp., commercial groups. I think it would be worth doing. I say that as one who served as part of Allen Wallis' group of consultants and found that we did not have the time or the material to bring to bear enough attention on issues on which we were asked to give technical advice.

Mr. TILOVE. Broad is the answer. I don't think Government should abdicate its responsibility of direct involvement but I am sure that governmental studies can be structured in such a way so as to provide an openness and involvement on the part of all responsible parties concerned so that the results are sufficiently open, controversy is sufficiently aired, and various viewpoints have opportunity to get thoroughly involved.

Representative BOLLING. Now I will return to the more orderly procedure. When the time comes, Chancellor Wallis, leave as you must. We very much appreciate your being here.

Mr. WALLIS. Thanks. I will stay as long as I can. I am very much interested.

Representative BOLLING. Next, Robert Tilove, senior vice president of Martin E. Segal Co.

STATEMENT OF ROBERT TILOVE, SENIOR VICE PRESIDENT, MARTIN E. SEGAL CO.

Mr. TILOVE. Thank you, Mr. Chairman. We are obviously at a time when extensive amendment of social security has to be considered because of a number of simultaneous developments.

Additional financing is needed for the immediate future. The benefit escalation formula has to be replaced by something more stable, less likely to produce unintended results. A projected long-range increase in the ratio of beneficiaries to workers raises basic questions about ultimate financing and benefits.

Increasing payroll taxes have stimulated interest in ways of lightening the load on workers with low earnings and for increasing the role of general revenues in the program. Growing participation of women in the labor market and judicial decisions create a need for recasting provisions so that they will be sex-blind.

I will focus on a few issues which may perhaps be special within my area.

The notices by Alaska and New York City to terminate their participation in social security raise important questions about the costs and benefits of social security.

TERMINATION OF COVERAGE BY A STATE OR LOCAL GOVERNMENT

A unit of State or local government that has participated in social security for at least 5 years has the privilege of terminating that coverage after giving 2 years' advance notice. That privilege is a mistake that may prove to be very costly to the social security system. From the standpoint of the national interest, it is a privilege which can and should be ended.

Withdrawal leaves the social security fund with a huge benefit liability, the cost of which has to be picked up by all other employers and employees. If a public unit leaves, it stops contributing but it does not take with it the obligation to make future payments for accrued benefits. If a public employee has been covered by social security for at least 10 years, he or she has permanent entitlement to its retirement benefits, even though participation is terminated well before retirement.

Commissioner Cardwell testified before the House Ways and Means Committee that if half the employees of State and local government who are presently covered withdrew, it will mean a loss of contributions in the 5-year period 1978-82 of over \$37 billion, not offset by diminution of benefit payments.

Employees of State and local government comprise about 11 percent of total social security coverage. On that basis, I would confidently estimate that if all of them were to be withdrawn from social security coverage it would require an increase in the social security contribution of at least 1.3 percent of taxable payroll for each of the succeeding 10 years. That would be an increase over and above the increase in revenue now known to be needed to overcome the near term shortfall and to restore the trust fund to its 1-year contingency position.

In correcting the error of permitted withdrawal, the difficulty is in finding an effective way that will be both constitutional and equitable.

The answer, in my opinion, dovetails into the matter of the mandatory coverage of public employees.

There is fundamentally no reason why public employees should be exempt from social security. Employment is mobile, public employment is a large part of the total, and social security coverage should continue whether a worker is in a public or private job. The program provides benefits which are worthwhile and which are designed to minimize poverty. Moreover, those public employees who are exempt enjoy a windfall at the expense of the social security fund. Most of them draw social security benefits based on covered employment before, after, or during their public employment at the relatively favorable percentage intended for low-wage workers. For all of these reasons—their own protection by fully portable benefits, early disability benefit coverage, and valuable survivors insurance; the general welfare; and elimination of the waste of social security funds on windfall benefits—there ought to be universal mandatory coverage.

The Advisory Council so recommended.

However, it would not be appropriate to mandate social security coverage on those present employees of Federal, State or local government who are currently outside social security and who are covered by a staff retirement system. That would pyramid the costs.

The contributions and benefits of those systems have been firmly fixed in the light of noncoverage by social security. It would not be reasonable to add social security contributions and benefits on top.

The legislative action I respectfully recommend would be mandatory coverage for all public employees except for any present employee who is not already covered by social security and who is covered by a staff retirement plan. Also any employee who is hired within the next 3 years and is in the same position should remain outside the mandate.

That would mean :

(1) No change in the status of present public employees who are outside social security.

(2) Employees hired in the next 3 years would be in the same position.

(3) Each jurisdiction not presently under social security would have 3 years within which to establish a retirement plan for those of its employees who will have mandatory social security coverage.

(4) Mandatory coverage would apply immediately to all Government units that now have coverage; in short, universal coverage would make withdrawal moot.

You might get out on Monday. You would be covered on Tuesday.

A significant result of universal coverage is that it would strengthen both the short-term and the long-term financing of social security.

First, by shutting the door on withdrawal, it would put an end to that potential drain on the social security fund.

Second, as new employees were hired starting, let us say, in 1981 it would bring in additional contributions; without for the time being, adding very much to benefit payments. These additional contributions would multiply rapidly as the cohort of employees hired after 1980 increased, so that within a few years the extra contributions would be in the billions, while still without anything approaching offsetting benefit payments.

The third effect would be to improve the long-term financing. Exempt coverage is a drain on the social security fund because of the windfalls which fall to exempt public employees who have also had some covered employment.

Universal coverage would stop that unnecessary cost. This result would not be achieved at once, of course, because present exempt employees would remain exempt. But it would be accomplished gradually over the next 30 years. It would strengthen financing by eliminating a source of waste that is bound to be an increasing source of embarrassment to the social security program.

Granted, there is a constitutional question raised about compulsory coverage, but I think it should be faced.

Compulsory coverage of the employees of State and local government would, of course, run into a constitutional question. However, the issue concerns the general welfare in a highly mobile society in which a lifetime of work frequently involves both public and private employment, and the mandate would apply uniformly to all employees and all employers.

Moreover, it would seem possible to include clearly constitutional sanctions, such as conditions for Federal grants having a welfare component or a fall back provision for taxation on the employees—which would make the constitutional issue academic.

The court decisions on sex discrimination may very well involve the social security system in a search for a solution. We will soon face the question whether the male spouse of a female employee entitled to social security is entitled to the spouse's benefit, the 50-percent benefit.

That may very well turn out to be the man who has had a lifelong career with the Federal Government in an exempt position.

The Advisory Council faced that question, thus applying only to the widow's benefits. The Advisory Council suggested that, to avoid that unnecessary cost, there be an offset by staff plan benefits payable by the Federal or State or local government against the spouse's or the widow's or the widower's benefit, but it explicitly refrained from applying that offset to a benefit payable on the account of the worker himself.

But once an offset proposal is incorporated in the law the question arises whether the windfall benefits of a person largely engaged in noncovered employment but arising from the entitlement stemming from covered employment, whether that same solution might perhaps be applied to whittle the benefits down.

The benefit would be proportionate to the earnings that were actually earned in covered employment.

THE SOURCE OF GREATER CONTRIBUTIONS

Suggestions for the increased income needed to meet the short-term deficiency have included increased rates, an increase in the wage base, general revenues, and combinations of two or more of these.

An increase in the wage base, for example, to encompass all of the earnings of 90 or 95 percent of the employees, would add to the revenue, but also, ultimately to benefit payments. However, there is a break-even point—an increase in the base can permanently bring in more than it pays out if the replacement ratio on the wage increment is sufficiently modest. In other words, 11 percent will bring in at least as much as the 22 percent that might be paid out in benefits in replacement of that increment in the taxable wage base. The further question that arises is the role of general revenues.

I must confess to a split opinion on that in my own mind. It is this: I think we all recognize that the vast acceptance and success of social security has rested on its acceptance by the American people as a system that stays away from means tests and welfare, that bases benefits on the matter of earned right and the fact that it is based on calculated contributions from the employers and the employees is a large part of that entire logic.

The introduction of general revenues in a way that undermines that logic would not be desirable, but it may be possible to introduce general revenues in a way that does not undermine that logic.

For example, and Mrs. Rivlin put her finger on this—there are welfare objectives that are directed toward its goal of social adequacy and they may be referred to as nonwage-related benefits—these might either at once or more likely on a phased schedule be shifted over to general revenue financing in one fashion or another and that would provide a new source of underpinning for the social security system and also provide for greater correspondence between the payroll tax and the benefits based on the payroll tax.

For example, may I suggest something as a highly tentative proposal which I must confess I have not thought through but which may sufficiently illustrate the possibilities for doing precisely that and solving some problems in many directions?

Suppose we had a two tier system as many countries do. One might be a flat grant to every oldster, every person let us say 65 or older of

\$100 a month indexed for the future by let us say wages or perhaps cost-of-living but indexed in any event.

Starting with \$100 a month for any oldster and financed by general revenue, make that grant taxable. Make it independent of any other circumstance, income or earnings.

Then as a second tier supplement it by a strictly wage-related program in which the wages would be wage indexed over time and would provide a replacement ratio of perhaps 25 or 30 percent or as another variation you could provide 30 percent on a first base of wages and a lesser ratio such as 20 percent on a higher portion of wages.

That is extremely simple: One tier of \$100 indexed to everyone, payable and taxable. Another tier, wage-related, 25 percent to 30 percent, or maybe with a break point to make it somewhat more progressive.

There is nothing very novel about the idea. Several countries do precisely that. This sort of change has many implications. General revenue would be applied to make the payment to every or practically every senior citizen and part of the payment would come back to the Government in the form of taxation.

The problem of inequity as between the simple worker couple and the two-worker couple and the related problem of the rather meager increment which is earnable by a wife's work would be eliminated. Each oldster would get \$100 indexed plus a strictly wage-related benefit based on the two accounts or the one account.

Third, the burden on the payroll tax would be lightened or abated.

Fourth, since it would be payable regardless of work after 65, the demogrant part would reduce the problem of post-retirement work tests. It might not entirely eliminate it but it would reduce it.

Fifth, the addition of the \$100 as the fundamental benefit gives a proper tilt to the combined benefits in favor of a lower paid worker.

Sixth, it makes an allowance for the spouse who has not been in the labor market and I think there should be an allowance for a spouse who has not been in the labor market.

Seventh, it makes the benefit formula extremely simple and its equity readily understandable.

The formula, if you try it out for awhile, comes rather close to reproducing in a very general way the results of the present social security program.

But that is not surprising. The idea takes the social adequacy weighting embodied in the social security formula and converts it into a flat benefit. This applies both to the weighting for the low paid and the add-on for wives.

The idea is far-reaching and an objection to such an idea is that it may be too abruptly different, perhaps. But that should not discourage consideration of such a notion. If it is too abruptly different, phase-ins would be required. Phase-ins of various types are not difficult to work out.

I think there is unanimity that the escalation formula has to be corrected and I would favor a correction along the lines of the Advisory Council to the effect of some sort of a maintenance of the wage replacement ratios.

As the committee knows, a correction of that kind would take out perhaps half of the projected long-term cost increases.

One final comment on the long-range increases. There are immediate cost increases, intermediate and long range. The question will present itself, how do you do that? Do you wait until the cost jumps and then increase the rate? Or do you incorporate it completely, the projections to the year 2010, 2050 and so forth, in a vast rate increase now? Or do you graduate it? I would strongly recommend and I think it would come to be regarded as inevitable under the circumstances that you graduate any scale of taxation necessary to meet the now projected cost increases.

A graduation may involve for the near and intermediate future the accumulation of a reserve somewhat greater than now exists purely as an incident of graduating toward a projected larger increase in the distant future.

But that is not bad. Let's for a moment go far out to the year 2010 at the time when our now famous baby boom begins to retire and it looks as if we face a large increase in cost. Put ourselves in the position of the then social security actuary.

He looks at a 75-year projection and he finds that the baby boom increase is temporary for only 20 years. Thereafter the cost will abate. He says to himself, we wouldn't have to increase the tax rates quite this much if we only had available now a sufficient reserve fund to see us over a few years of this bulge.

If you proceed to graduate the increase, you will incidentally accumulate a reserve which will help to flatten out somewhat the temporary bulge of 2010 to 2030. In the second place you will give yourself the freedom to reassess from time-to-time whether or not the next tax increase should be less or should be greater.

You can accommodate to those projections. Thank you.

[The prepared statement of Mr. Tilove follows:]

PREPARED STATEMENT OF ROBERT TILOVE¹

SOCIAL SECURITY BENEFITS AND FINANCING—SOME SHORT-TERM AND LONG-TERM ISSUES

We are obviously at a time when extensive amendment of social security has to be considered because of a number of simultaneous developments.

Additional financing is needed for the immediate future. The benefit escalation formula has to be replaced by something more stable, less likely to produce unintended results. A projected long-range increase in the ratio of beneficiaries to workers raises basic questions about ultimate financing and benefits. Increasing payroll taxes have stimulated interest in ways of lightening the load on workers with low earnings and for increasing the role of general revenues in the program. Growing participation of women in the labor market and judicial decisions create a need for recasting provisions so that they will be sex-blind.

The notices by Alaska and New York City to terminate their participation in social security raise important questions about the costs and benefits of social security.

TERMINATION OF COVERAGE BY A STATE OR LOCAL GOVERNMENT

A unit of state or local government, that has participated in social security for at least five years has the privilege of terminating that coverage after giving two years' advance notice. That privilege is a mistake that may prove to be very costly to the social security system. From the standpoint of the national interest, it is a privilege which can and should be ended.

¹ This statement is personal and not necessarily the view of Martin E. Segal Co.

Withdrawal leaves the social security fund with a huge benefit liability, the cost of which has to be picked up by all other employers and employees. If a public unit leaves, it stops contributing but it does not take with it the obligation to make future payments for accrued benefits. If a public employee has been covered by social security for at least ten years, he or she has permanent entitlement to its retirement benefits, even though participation is terminated well before retirement. If the employee is close to retirement, there is little or no diminution in benefit amount. If the employee still has years to go before retirement, his or her benefit amount will be diminished, by the inclusion of zeros in determining his average monthly earnings, but the shrinkage is less than proportionate because of the weighting of the social security in favor of the lower-paid. (In this case, of course, they would not be lower-paid, but would get the advantage of that weighting anyhow). The result is that withdrawal leaves the social security fund with large liabilities, unmatched by contributions, and a consequent need for greater financing by everyone else.

Commissioner Cardwell testified before the House Ways and Means Committee that if half the employees of state and local government who are presently covered withdraw, it will mean a loss of contributions in the five year period, 1978-82, of over \$37 billion, not offset by diminution of benefit payments.

Employees of state and local government comprise about 11 percent of total social security coverage. On that basis, I would confidently estimate that if all of them were to be withdrawn from social security coverage it would require an increase in the social security contribution of at least 1.3 percent of taxable payroll for each of the succeeding ten years. That would be an increase over and above the increase in revenue now known to be needed to overcome the near-term shortfall and to restore the trust fund to its one-year contingency position.

In correcting the error of permitted withdrawal, the difficulty is in finding an effective way that will be both constitutional and equitable.

The answer, in my opinion, dovetails into the matter of the mandatory coverage of public employees.

There is no reason why public employees should be exempt from social security. Employment is mobile, public employment is a large part of the total, and social security coverage should continue whether a worker is in a public or private job. The program provides benefits which are worthwhile and which are designed to minimize poverty. Moreover, those public employees who are exempt enjoy a windfall at the expense of the social security fund. Most of them draw social security benefits based on covered employment before, after, or during their public employment at the relatively favorable percentages intended for low-wage workers. For all of these reasons—their own protection by fully portable benefits, early disability benefit coverage, and valuable survivors insurance; the general welfare; and elimination of the waste of social security funds on windfall benefits—there ought to be universal mandatory coverage. The Advisory Council so recommended.

However, it would *not* be appropriate to mandate social security coverage on those present employees of federal, state, or local government who are currently outside social security and who are covered by a staff retirement system. The contributions and benefits of those systems have been firmly fixed in the light of non-coverage by social security. It would not be reasonable to add social security contributions and benefits on top.

The legislative action I respectfully recommend would be mandatory coverage for all public employees except for any present employee who is not already covered by social security and who is covered by a staff retirement plan. Also, any employee who is hired within the next three years and is in the same position should remain outside the mandate.

That would mean:

1. No change in the status of present public employees who are outside social security.

2. Employees hired in the next three years would be in the same position.

3. Each jurisdiction not presently under social security would have three years within which to establish a retirement plan for those of its employees who will have mandatory social security coverage.

4. Mandatory coverage would apply immediately to all government units that now have coverage; in short, universal coverage would make withdrawal moot.

A significant result of universal coverage is that it would strengthen both the short-term and the long-term financing of social security.

First, by shutting the door on withdrawal, it would put an end to that potential drain on the social security fund.

Secondly, as new employees were hired starting, let us say, in 1981 it would bring in additional contributions, without, for the time being, adding very much to benefit payments. These additional contributions would multiply rapidly, as the cohort of employees hired after 1980 increased, so that within a few years the extra contributions would be in the billions, while still without anything approaching offsetting benefit payments.

The third effect would be to improve the long-term financing. Exempt coverage is a drain on the social security fund because of the windfalls which fail to exempt public employees who have also had some covered employment. Universal coverage would stop that unnecessary cost. This result would not be achieved at once, of course, because present exempt employees would remain exempt. But it would be accomplished gradually over the next 30 years. It would strengthen financing by eliminating a source of waste that is bound to be an increasing source of embarrassment to the social security program.

Compulsory coverage of the employees of state and local government would of course run into a constitutional question. However, the issue concerns the general welfare in a highly mobile society in which a lifetime of work frequently involves both public and private employment and the mandate would apply uniformly to all employees and employers. Moreover, it would seem possible to include clearly constitutional sanctions—such as conditions for federal grants having a welfare component or a fall-back provision for taxation on the employees—which would make the constitutional issue academic.

There is, of course, no constitutional problem to deter the federal government from bringing all its future hires into social security. The employer contribution would, in fact, be a gradually increasing stream of income to the trust fund from general revenues.

DEALING WITH THE WINDFALL BENEFITS OF EXEMPT EMPLOYEES

Whether legislation should eliminate the windfall benefits of non-covered employees is a separate question. It is bound to be a highly sensitive issue because, right or wrong, these include benefits that have, to one extent or another, already accrued under the existing law.

Yet, the issue may soon be unavoidable, at least in a limited form.

The courts have already decided that a widower is entitled to the benefits payable to a widow caring for the minor child of a deceased insured worker. Then there will be the case of the husband who will sue for the 50 percent spouse benefit, while he is receiving a public employee pension for non-covered employment and the further case of a surviving aged widower who will ask for the benefit payable to a widow even though he, too, is on a pension based on non-covered employment. As it is, a woman who is receiving a social security benefit as a wife or as an aged widow may also be receiving a pension from her exempt public employment that was designed as if she had no social security benefits.

Considering the possibility that changes to make the Social Security Act sex-blind would vastly increase such windfalls, the 1974 Advisory Council recommended that a pension payable on the basis of non-covered employment be offset from any spouse or surviving spouse benefit under social security. It was explicit in not recommending such a deduction from the worker's own social security benefit.

However, if an arrangement for offset is to be established, might it then be asked whether it could be applied so as to shrink to non-windfall proportions the social security benefit to which an employee in non-covered employment will be entitled on the basis of his pieces of covered employment? These social security benefits might, for example, be calculated, as a first step, on all his earnings but paid only for that portion ratably attributable to his covered earnings.

It is worth reiterating that the proposition of making coverage universal is entirely separable from the question of the windfall benefits of presently non-covered employees. However, if universal coverage were mandated and steps were considered toward eliminating the windfalls, then it would be appropriate simultaneously to consider measures to make sure that no employee still in non-covered employment would fall between social security and his benefits as a public employee. This might be done on some basis involving specifically

calculated transfers to the social security fund. It is a problem to which considerable thought has been given at the federal level and some of the same approach might also be applied for state and local governments.

THE SOURCE OF GREATER CONTRIBUTIONS

Suggestions for the increased income needed to meet the short-term deficiency have included increased rates, an increase in wage base, general revenues, and combinations of two or more of these.

An increase in the wage base, for example, to encompass all of the earnings of 90 or 95 percent of the employees, would add to revenue, but also, ultimately to benefit payments. However, there is a break-even point—an increase in the base can permanently bring in more than it pays out if the replacement ratio on the wage increment is sufficiently modest. If it proves true that 40 years from now there will be only two active employees for each beneficiary, then any legislated increment in the wage base will return a net gain to the fund if the benefit ratio on that wage increment is less than double the total contribution rate. For example, if the combined contribution rate for OASDI is 11 percent, a replacement ratio of less than 22 percent on the highest segment of earnings will yield a net gain to the fund on that segment of the wage base.

There is a good case for applying general revenues for the "welfare" aspects of social security, that is, those features that represent social adequacy as distinguished from individual equity.

However, one of the strongest underpinnings of social security is its acceptance as social insurance paying benefits earned as a matter of right on the basis of employer and employee contributions. It is therefore a legitimate concern, in my opinion, that general revenue should be applied in so distinctive a way that it does not undermine that concept.

THE POSSIBILITIES OF A TWO-TIERED BENEFIT SYSTEM

Social security has always balanced two objectives; individual equity, based on earnings in covered employment, and social adequacy. Increasing costs have put a strain on accomplishing both within payroll taxes. That fact, plus the developments to which we have referred, suggest that it may be worth considering changing the benefit structure.

The following is therefore advanced, not as a proposal that has been entirely thought through, but as a possibility worthy of serious consideration.

Suppose social security were recast so that it would consist of two layers instead of one. The first would be a demogrant of, let us say, for example, \$100 per month, paid to everyone upon attainment of a particular age, for example, 65. The coverage might be every resident or it might be limited to those eligible for social security and their wives and husbands. The \$100 would be automatically updated by an indexing formula. It would be taxable.

The second layer would be strictly related to average indexed earnings in covered employment. It would be a benefit payable in the full amount upon retirement at or after age 65. It might be 25 or 30 percent of average monthly indexed earnings. Or it might be 30 percent to one level and 20 percent on the highest segment of covered earnings.

There is, of course, nothing very novel about this idea. There are several countries that have two layers in their national programs: the first, a flat pension for everyone and the second, a graduated social insurance plan.

This sort of change would have many implications. Among the more obvious are these:

- (1) General revenue would be applied to make payment to every "senior citizen" (or alternatively those within the scope of the system) and part of the payment would come back to the government through taxation.

- (2) The problem of inequity as between the one-worker couple and the two-worker couple and the related problem of the meager increment earnable by a wife's work would be eliminated. Each "oldster" would get his or her wage-related benefit plus the \$100 a month.

- (3) The burden on the payroll tax would be lightened or abated.

- (4) Payable regardless of work after 65, the flat grant would reduce the problem of the post-retirement work test. Of course, to the extent that a beneficiary continued to work, part of the benefit would return to the federal government in the form of taxes.

(5) It gives the proper tilt to the combined benefits in favor of the lower-paid worker.

(6) It makes an allowance for the spouse who has not been in the labor market.

(7) The benefit formula would be extremely simple and its equity readily understandable.

This formula comes rather close to reproducing, in a very general way, the results of the social security program. That is not surprising. What this idea does essentially is to take the social adequacy weighting embodied in the social security formula and convert it into a simple flat benefit. That applies both to the weighting for the lower-paid and the add-on for wives.

This idea is, of course, far-reaching. That it is different should not exclude it from consideration. If anything comparable were adopted, it would have to be phased in by one means or another, and the extent of financing by general revenue could also be graduated.

CORRECTING THE ESCALATION FORMULA

There seems to be unanimity in favor of changing the escalation formula, but not on what should take its place. It would seem desirable to set a goal in terms of wage replacement and fulfill it as steadily and equitably as possible by careful choice of a formula for indexing creditable wages from the time they were earned to the time for retirement.

As your Committee no doubt knows, this change would take a large part out of the otherwise projected cost increases.

THE LONG-RANGE INCREASES

A long-range increase in cost is nevertheless in prospect—a slow increase for many years and then a substantial jump in the years 2010 to 2030, when the post-war "baby boom" retires and finds that fertility rates at or below "zero population growth" have produced little more than two workers to support every beneficiary.

Those costs may or may not develop as projected. There are many variables and they may change, remarkably before 2010. It is even possible that retirements in 2010 will create a labor shortage with the effect, subsequently, of holding able-bodied employees back from retirement. Nevertheless, it would not be prudent, wise, or responsible to ignore the projections.

One of the questions to be resolved is how to phase or schedule the increased financing—should it be incorporated as a level rate, substantially higher than the present rate, or should the rate increase only as the cost increases, or should the increase be smoothly graduated. I would respectfully suggest the last of the alternatives.

An abrupt increase is undesirable at any time—now or in 2010. A graduated increase would spread the burden over time and over the generations. It would mean that during the next few decades, contributions would exceed expenditures and a substantial trust fund would accumulate. Under the circumstances, that would have a major advantage.

Let us assume that contributions do no more than meet current costs as they develop. Let us suppose we are at the year 2009 and it appears, as now projected, that a substantial increase in contributions is required immediately and for the following 20 years. However, if the social security actuary then in office were to do a 75-year projection he would find, by present assumptions, that the "baby boom" effect would last only 20 years and be succeeded by lower costs based on a more "normal" ratio of active workers to beneficiaries. He would therefore observe that is a substantial trust fund were then on hand it might help materially to see the program through its highest-cost years without commensurate increases in contributions. In other words, the reserve would help to smooth the peak.

Of course, this is a very long look into the future, yet the most responsible course is to prepare to meet the problem in ways that leave flexibility for adjustment and readjustment as the changing circumstances and projection unfold.

Representative BOLLING. Thank you, Mr. Tilove.

I have discovered since I said that we would go back to the regular order that Senator Percy has to leave to go to a committee meeting. I am going to ask him to proceed with any questions.

Senator PERCY. Thank you, Mr. Chairman, very much indeed. I will ask only one question of my old friend, Allen Wallis. Do you feel that we should act this year in Congress?

We are slower in election years to raise costs. Do you think we should act in the situation—would it warrant immediate action this year to correct some of the problems we face in financing social security?

Mr. WALLIS. I think the Congress ought to act on the decoupling issue this year. That is a fairly simple issue in the sense that politically it is a simple issue.

I haven't heard anybody object. On our Council, that was one of the few things everybody was for.

Senator PERCY. If it is difficult for people to understand what is happening, it is easy for politicians to decouple, take away a windfall which they don't know they have.

Mr. WALLIS. The effect of the windfall is not great, whereas if it is allowed to ride for a year or two, it will become a serious problem. It may be difficult then to repeal it.

If you were to try to make further changes at this time I doubt that you would do it without opening up a wide range of topics which could not possibly be dealt with in this session.

The problem I consider next-most-urgent is to get welfare things out of the earnings-related tax. The Advisory Council recommended that medicare be financed out of general revenue or at least not financed out of an earnings related tax.

You may remember that when our report was issued, before it even hit the streets, the administration denounced it; both the Secretary of HEW and the White House denounced it for recommending general revenue funding.

We said we were against general revenue funding but that those benefits not related to earnings ought not to be financed by earnings-related taxes. The biggest of these non-earnings related benefits is medicare. That I would consider the next most important priority, to clean out some of these welfare things that are now supported by earnings related taxes.

I can't believe, as a practical matter, that that can be done in this session of Congress. The adjustment of the technical error, it seems to me, might have a chance. There is no opposition I have heard of. No doubt some will crop up.

Senator PERCY. Do you think, though—one last question to you—it is presumed that it is good politics to go vote for benefits and not to vote for taxes. Do you think in the end that people are so stupid as to think that that system can go on forever? Isn't an overriding concern now in a lot of people's minds the integrity of the system itself and that it would be wary of someone who kept passing benefits out, increasing costs and not being willing to say this is what has to be done to scale down in some other area for increased income?

Mr. WALLIS. This is such a huge country and it is so diverse and I am in contact with so little of it that I could not judge how the public reacts to those things. Certainly there is a great deal of concern about the soundness of the social security system.

But in connection with the tendency of Congress to vote increases in benefits, it is possible—and I may have been guilty of this—to

exaggerate the effects of the over-indexing that results from the faulty cost of living adjustment. The actual fact is that before the automatic cost of living adjustment was introduced the record was the same. Benefits have gone up twice as much as prices over the entire history of the social security system, and also over relatively short periods, a decade or so. As I recall, there have only been two periods when benefits lagged behind the cost of living. So the faulty cost of living adjustment merely automated a phenomenon that in fact Congress was performing anyway, of raising the benefits far more than the cost of living. I think it is possible that by focusing our attention on the fact that a technical error was made, we divert attention from the fact that if it had not been for the technical error, Congress would be overadjusting the benefits anyway.

Senator PERCY. I know you have to leave. Thank you very much for your appearance today. The suggestion has been made that we ought to make the universal coverage mandatory and plug up this possibility as policemen and firemen in Chicago have, of people, organizations and localities who want to pull out of the system.

There was a comment on the Today program this morning. The question was how do you feel about universal coverage and should we make it a compulsory system all the way across the board rather than having as many Government employees going out?

Mr. FELDSTEIN. I don't think there is a moral reason why Government employees have to be covered. But a practical matter, all people should be covered because of benefits for survivors and things such as that. We can rely on the SSI program to create the minimum benefits.

I would be in favor of blanketing in everybody.

Mrs. RIVLIN. I agree. It would simply make it easier for the Congress to deal with the problem if everybody were covered. The reason, of course, that the State and local employees were not originally covered has to do with the constitutional law questions that I am not competent to discourse on.

But I think, over the years, the judges have become a little bit looser about this question of the State and Federal relationship. There was a time when the State employees did not pay Federal income tax. Now they do. From the point of view of the policymaker in the Congress grappling with what we want to do about retirement income, it makes it easier if everybody is covered by the same system and cannot move in and out at will or introduce the complication of a relationship between other public systems.

Senator PERCY. Do you believe, as Mr. Wallis has said, that decoupling is difficult to understand but easy to correct?

How would you go about correcting it and how soon do you think we should? I would like to have a brief comment from each one of you on that.

Mrs. RIVLIN. Yes. It is a little bit difficult to understand but I think the basic principle is a clear one. We introduced into the social security system an automatic increase in the benefits when the cost of living goes up. To apply that automatic increase to the wage replacement factor, when wages are also going up, does seem clearly to overcompensate.

That is not such a difficult idea. I think Mr. Wallis is right, that once the idea is clear, although the exact way of correcting it may

be a little technical, everybody is pretty much agreed that something ought to be done.

I don't think it is a big political issue.

While it is not necessary for the Congress to address this problem this year, the longer you wait, the harder it will be.

Mr. TILLOVE. I think it is unanimous that the so-called decoupling should take place. What should replace it may get to be a little controversial. I can foresee moreover that in the process of creating the new formula, some of the other questions will necessarily insinuate themselves. The process may take, let us say 2 years.

I think there is nothing fatal that happens if it does take 2 years. The principal considerations are that the public should be reassured that the social security system is going to pay benefits. That is a question of taking reassuring action with respect to the short-term financing, and taking some action which assures the country that the decoupling error will be corrected and a sound formula will take its place within the near future.

Senator PERCY. We are faced with a decision of what to do. I think the great value of the Joint Economic Committee and the foresight that Congressman Bolling has had is to say—is to look at the reality. The House Ways and Means Committee and the Senate Finance Committee do not seem to be moving this year.

We are creating a forum of public discussion and understanding of something which has to be done. Let's get going on these things.

The administration has cleared its conscience by proposing a six-tenths of 1 percent increase. Other proposals have been made. Mrs. Rivlin has made a number of proposals as to what can be done.

Would each one of you take a moment to say what you think if you were sitting in our seats with the responsibilities—if it means raising rates, I am going to propose it and support it and fight for it. What would you do with respect to rates?

Do you support the administration's proposal and if not, what combination of raising rates or income levels and so forth would you support to bring income more in line with outgo?

Mr. FELDSTEIN. I think that there is no urgency about doing something within the next six months or twelve months, even though the reserves are being depleted within the next few years.

I think something has to be done within the next 2 or 3 years. On the yellow sheet, I have listed eight recommendations. With respect to the current point, A and H are the relevant recommendations. I would raise the tax rate within the next 3 years by something on the order of the administration's proposal and I would not raise the relative maximum taxable earnings. The taxable earnings of \$15,300 today are higher than the earnings of 85 percent of the covered employees. I think there is no long-run gain and there is a substantial long-run economic loss of raising that to cover, say, 90 percent or everyone, as has sometimes been proposed. I would get the extra revenue from an increase in the tax rate in the short run. In the long run, I would look to restructuring more benefits.

Senator PERCY. Mrs. Rivlin.

Mrs. RIVLIN. The Congressional Budget Office does not make recommendations on specific policy. But let me say that it is not necessary

to do anything in the next 2 years with respect to protecting against actually running out of reserves.

I think it is probably a good idea for the Congress to make clear that that is true, lest people worry. The thing that is needed in the near term is the restructuring of the disability fund which is an immediate problem area.

There is no doubt about that and something has to be done about it fairly soon. The decoupling issue should be faced, and the sooner the better. The whole question does seem to give the Congress the opportunity to reexamine the social security system in a broader context and to think about what we, as a Nation, want to do about levels of retirement, disability, and survivors' benefits over the foreseeable future, and what are the various ways of paying for these.

It would seem to me that we should start thinking about that whole question right now. We should not be panicked into immediate action but keep in mind that some action will be necessary, probably within the next several years.

Mr. FELDSTEIN. Can I add one more point? I think you want to disassociate the question of what to do about the social security fund from the general issue of overall tax policy. Much of the opposition to raising the tax rate comes from those who fear it will slow down the recovery and those who fear it will add the regressivity of the system.

Surely at the same time you change this tax, you can change other taxes. On balance, there need be no adverse economic effects and no adverse effect on the progressivity of the tax system. It is important not to allow the viability of the social security trust fund to be jeopardized because you failed to look at the picture as a whole and focused on the social security tax alone.

Senator PERCY. There is no jeopardy unless we fail to act at all. Shouldn't we just act now and make the effective date sometime in the future so we can unequivocally say we have acted, it is going to take effect, and no one has to worry?

Nobody has to ask, am I going to have to worry about getting my social security benefits when I retire?

Mr. FELDSTEIN. People of my age are going to have to worry about it, but not because of the size of the trust fund, but rather because of the political support of the program. Unless something substantial occurs to change the structure, there will be opposition after the turn of the century.

Mr. TILLOVE. I sympathize with the position of those in Congress and others concerned with social security that you have to reassure the public. At a minimum it seems to me, action should be taken now to reassure the public that an answer will be provided by next year.

In other words, this thing should not be allowed to lie idle. I am staggered with the amount of talk, including talk by journalists, which centers around the possible bankruptcy of the social security system. An effective answer to that is to provide visible evidence that Congress knows the situation, is in control of it, and is doing something about it.

I am not prepared to say precisely what the answer should be. I am more sympathetic, I suppose, to an increase in the tax base, restor-

ing somewhat the broader coverage of all earnings that it had when the program first started.

I think that can be done without overcompensating disbursements in the long run.

Senator PERCY. We have provided for increases in the tax base. You would accelerate that process?

Mr. TILOVE. Yes; believe it or not, originally the \$3,000 we started with took in 97 percent of the American people. Now it is down to 85. Were it restored to 90 or 95, I am not sure how much of the deficit it would cover, but if you did that and provided a modest increment in the benefit increment, you would get an immediate gain without a long-term loss.

Mr. FELDSTEIN. But that would probably reduce private savings by \$2 billion, \$3 billion, and maybe \$4 billion a year.

That is the cost of providing extra protection for people earning between \$16,000 and \$19,000. That has a different connotation than what it did in the 1930's.

Senator PERCY. I want to thank each of our witnesses, Mr. Chairman for adding a great deal to our better understanding. It is a complex problem. We need help, and I think you have been an immense amount of help to us. I wish to thank you, Mr. Chairman, for your customary courtesy and the concept of these hearings.

Representative BOLLING. Before I proceed to Mr. Feldstein's statement at long last, I am not clear in my own mind—I have been active in the political process for 30 years—I don't remember well enough whether this scare on the soundness of social security comes up every 2 years or every 4 years.

But I do have a clear feeling that it starts with some politicians and then quite naturally is exploited by a variety of other people because it does get the attention of a lot of people. I think it is very clear that we have to assure, reassure yet again—I don't know whether it is for the 15th time in my active political life or the 7½ time, we will have to do it again.

Mr. Feldstein.

STATEMENT OF MARTIN FELDSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. FELDSTEIN. Thank you, Mr. Chairman. One of the best things about this panel concept is that it brings out the diversity and the areas of agreement. As I listened I heard a great deal of agreement. I hope that adds to the credibility of what we are saying.

I will summarize my prepared statement by simply mentioning some of the other parts. I will list 10 basic facts that I think have to be borne in mind in thinking about social security and 8 recommendations that I draw from them.

First, the social security program is running a deficit now and depleting its small reserve fund. In 1970, the trust funds were equal to 15 months worth of benefits. Now they are only 8 months of benefits. Experts agree that continuing on the current course would lead to an accelerating rate of depletion of the present \$44 billion fund; if the current legislation is not changed, the trust fund will be exhausted by the early 1980's.

This method of indexing benefits to inflation that was introduced in 1972 contains a very important technical error. While adjusting benefits and taxable wages for inflation is clearly a good idea, it is generally agreed that the method used was technically wrong.

The recent demographic swing from baby boom to baby slump will eventually require a very large increase in the social security tax rate if the current relative benefit structure is to be maintained. The effect of this demographic swing will be to reduce the number of workers when the number of retirees is high. Today there are 30 retirees per 100 workers. Forty years from now there will be 45 retirees per 100 workers, an increase of 50 percent.

If the current pattern of benefit replacement ratios—that is, the ratio of benefits to previous earnings—is to be maintained, the tax rate would also have to rise by 50 percent, to 16 or 17 percent. If productivity growth is less than the 2 percent currently anticipated, the tax rate must rise even further.

Although there has been much concern about the social security program's unfunded liability of more than \$2 trillion, there is no economic reason why social security should ever be bankrupt. Current beneficiaries and covered workers are expected to receive over \$2 trillion in benefits more than they are expected to pay in future taxes.

If social security were a private pension plan, it would require current assets of more than \$2 trillion to be financially solvent, i.e., to guarantee its ability to meet its future obligations.

Since the social security program has a trust fund of only \$44 billion or some 2 percent of its obligations, social security is bankrupt by the conventional standards used to determine the actuarial soundness of private pension programs.

This analogy of social security to private pension programs is, however, totally misleading. A private pension program must have sufficient assets that any future contributions will be made. In contrast, the Government can continue to compel future generations of workers to pay social security taxes. The future tax rates can be set so that tax revenues are sufficient to meet the claims of the beneficiaries.

The Government's power to tax is its power to meet the obligations of social security to future beneficiaries.

As long as the voters support the social security system, it will be able to pay the benefits that it promises. It is therefore very important to prevent an increase in the tax rate or other changes that will undermine public support of social security's primary purpose: Providing basic income-related annuities that individuals otherwise would not or could not buy for themselves. Maintaining political support will become even more difficult because of the problem to which I now turn.

Social security retirees receive on average more in benefits than they and their employers paid in taxes during their working years. This excess of benefits over lifetime taxes is equivalent to earning a very high rate of return on the taxes paid.

Unfortunately this rate of return will fall sharply in the future so that social security will provide a much lower rate of return than private investment.

It is a very complicated issue and I explain it in my prepared statement.

With the full maturity of the social security system the rate of return that participants will earn on their social security contributions will be limited to the growth rate of real wages, at most about 2 percent per year.

This fall in the rate of return will make social security much less of a good deal for participants than it was in the past. This in turn will reduce political support for a large social security program. When labor and management see that they can get a much higher return from private pension plans, their support for social security will turn to pressure for a much reduced program that concentrates on providing a more minimal level of benefits.

For many retirees, social security benefits exceed previous income.

A man who retires in 1976 and who always had median earnings in covered employment, now about \$8,500 a year, will receive benefits equal to 46 percent of his preretirement year's gross earnings.

If he has a dependent wife, he will receive one-half again as much or 69 percent of his previous maximum gross earnings. But based on \$8,500 of earnings, benefits would be \$5,865. But the social security benefits are untaxed while the earnings are subject to Federal and State income taxes and social security taxes.

Since the social security tax alone would be \$500, a conservative estimate of the total tax liability would be \$1,000. The \$5,865 of cash benefits actually replace 78 percent of the previous net earnings of \$7,500.

In addition, the beneficiaries also receive medicare benefits worth more than \$1,000 per aged couple. Because the benefit schedule is progressive, someone whose earnings were below the median would have an even higher replacement ratio.

Such high replacement ratios at retirement are inappropriate for middle and higher income couples. Recall that these high replacement ratios mean that the retiree receives from social security alone more than he was to earn in his thirties, forties and fifties when he had children to support, a mortgage to pay, and so forth. Moreover, these social security benefits are often supplemented by private pensions.

It is ironic and sad that social security forces many families to cut their spending even when their income is low and their responsibilities are great in order to have more to spend during retirement when their income is already high as it has ever been.

Social security does not prevent poverty in old age. The prevention of poverty in old age is now the responsibility of the supplemental security income program that began in 1972. This is a means tested program financed out of general revenue.

Supplemental security income paid \$5.5 billion in fiscal year 1975. This was often supplemented by State funds. Supplemental security income is a welcome improvement since social security itself never succeeded in eliminating poverty, especially among widows and older retirees.

Two-thirds of American employees are covered by private pensions. Private pensions coverage, including the pensions of government employees, has grown rapidly and now covers at least two-thirds of American employees. The percentage is even higher if part-time workers and persons under age 25 are excluded.

- It would not be too much of an exaggeration to say that every employee who can expect to benefit from social security is also covered directly or indirectly by a private pension plan.

Most of the employees not covered by private pension plans are low wage workers who in old age will be supported by Supplemental security income rather than by earned social security benefits or wives whose husbands are covered by private pension plans.

The lack of progressivity of the payroll tax is irrelevant. The social security payroll tax has been criticized because, unlike the personal income tax, it is not progressive but proportional up to a limit and then ceases to increase.

It is, however, inappropriate to focus exclusively on this tax instead of seeing it in the context of the entire fiscal system. First, the benefits are progressively related to the taxes so that the social security program as a whole is progressively redistributed. Second, the Federal personal income tax rates can be adjusted to achieve any overall degree of progressivity for middle and upper income taxpayers. Finally, the new rebatable earned income credit can be extended to all low income families in order to offset the burden of the payroll tax to the extent that Congress desires.

More than one-half the married women are now in the labor force. The current labor force participation rate of married women has more than tripled from the 14 percent recorded in 1940. The social security program's treatment of dependent spouses and of working wives was designed for the very different conditions that prevailed in the past.

Under current rules many working wives pay taxes all their life but receive no more in benefits than they would if they had not worked.

Social security substantially reduces capital accumulation. For most Americans, the social security program is the major form of saving. With social security, it is possible to do little or no savings through bank accounts or private pension plans and still have a high standard of consumption during retirement.

Because individuals substitute social security for such private saving, total private saving and private capital accumulation is reduced. Because of our current pay as you go method of financing social security, the tax receipts are paid out as concurrent benefits and are not accumulated.

There is no real investment of social security benefits to offset the reduction in private saving and investment. The result is a fall in our Nation's rate of saving and in our capital stock.

The problem of not having a social security trust fund is that it weakens the capital stock of the Nation, that it lowers productivity and lowers real wages.

I believe this fall in saving is very large. The 1975 social security tax receipts of more than \$75 billion were nearly as high as the \$90 billion of personal saving. The fall in our capital stock may exceed \$1 trillion or a reduction of more than 25 percent.

With less capital, there is a lower level of productivity, lower wages and fewer good jobs. By reducing private saving, through social security, we deny ourselves the opportunity to invest with a rate of return to the Nation of 15 percent and limit ourselves to the implicit

return of only 2 percent that social security will provide in the future.

Let me turn now to a set of eight recommendations that deal with the problem raised above.

The tax rate should be raised within 3 years to eliminate the short-run deficit. There is no need for an immediate tax rate increase but failure to do so within 3 years is likely to precipitate a crisis that would long undermine confidence in the system.

The longrun financial problem that results from the changing demographic structure of the population would also be dealt with by increasing the tax rate from the current 11.7 percent to somewhat between 18 percent and 25 percent, depending on what happens to productivity and fertility.

Such an increase would be undesirable and is in fact unnecessary. There are two alternative policies that also deal more effectively with some of the other issues raised above.

Index the benefit formula so that future benefits and replacement rates depend on real and not relative income. The replacement rate should be geared to how much income the individual has stated in equivalent purchasing power.

This is different from the Advisory Council's recommendation and I find myself having changed my own view on this subject between the time that I was a member of the technical advisory group to that Advisory Council and now.

Next is then to develop a larger social security capital fund so that the deficit does not hit us all at once in the future. Let me just say that my fifth recommendation as we relax the earnings test and my sixth is that we reform the treatment of families and dependent wives.

The next recommendation is to raise supplemental security income benefits. The Federal standard for supplemental security income is very low, less than \$3,000 a year for a couple and less than \$2,000 a year for an individual. Despite this Federal program we are still leaving old people in large numbers in poverty. I believe we should spend more to eradicate the poverty of these older people.

Those who received social security benefits before we began in 1972 will find that their benefits today are very low because they retired so long ago. That is something that is not going to happen in the future because of appropriate legislated benefits.

Older retirees and women who became widowed many years ago have very low benefits today and could be singled out to have their benefits raised by a special expenditure of SSI.

Next is to tighten the relationship of benefits to previous contributions. Most Americans regard their social security contribution as a tax that entitles them to receive benefits but that is not closely related to the amount of those benefits.

When a man or woman earns \$5 an hour and has a take-home pay of \$4 an hour he regards the difference as a tax. He does not take into account the difference that is in social security.

That perception that it is a tax and the reality that it represents are unfortunate. It makes the social security tax very important for worker incentive. For most families this is more than a personal income tax. This is 12 percent tax on top of Federal, State and local taxes moving the tax rate from one-fifth or less of additional earnings to one-third.

When taxes take one-third of extra earnings or are so perceived there is bound to be an effect on work effort, job choice, willingness to get job training, or relocate, and so on. I think we can correct this view and see that they are going to get benefits back which are related to tighten the relationship between the contributions and subsequent benefits.

My final recommendation is not to raise the maximum taxable earnings from the current coverage of 85 percent of wages to 90 percent or more. This is an important subject that I hope we will have time to get back to but I think the disadvantages of that are not only the long-run drain that Mrs. Rivlin mentioned but also the important impact on savings that will begin to occur in the short run.

Let me end on a more general note. The basic features of our current social security program were designed more than 40 years ago under very different economic and social conditions. It is important that we now reexamine the structure of the program.

Only if our loyalty is focused on the purpose of social security rather than on its current form can it be revised, updated, strengthening its good features while reducing or eliminating some of its harmful effects. Thank you.

[The prepared statement of Mr. Feldstein, with an attachment, follows:]

PREPARED STATEMENT OF MARTIN FELDSTEIN

Thank you very much, Mr. Chairman. I am delighted to have this opportunity to talk with you and the other members of this very distinguished committee about the important problems now facing social security.

Your awareness of the short-run deficit and of the longer-run financial problems will help Congress to act wisely while there is still time. Dealing with these pressing problems will also provide an opportunity to strengthen and reform social security so that it can better serve our nation in the years ahead.

I have organized my remarks in two parts. I'll begin by summarizing ten basic facts that must be understood as a background to considering changes in social security. I will then make eight specific recommendations.

TEN BASIC FACTS

1. The social security program is currently running a deficit and depleting its small reserve fund

Total benefits paid under the OSADI program were \$2 billion more than payroll tax receipts during the most recent 12 months for which data are available. Benefits thus exceeded tax collections by 3 percent.

After adjusting for the interest received by the OASDI trust funds and for the administrative expenses, the trust funds lost \$900 million during those 12 months. To prevent this deficit would have required a tax rate of nearly 0.2 percent higher than it actually was.

In 1970, the trust funds were equal to 15 months worth of benefits. Now they are only 8 months of benefits. Experts agree that continuing on the current course would lead to an accelerating rate of depletion of the present \$44 billion fund; if the current legislation is not changed, the trust fund will be exhausted by the early 1980's.

The method of indexing benefits to inflation that was introduced in 1972 contains a very important technical error. While adjusting benefits and taxable wages for inflation is clearly a good idea, it is generally agreed that the method used was technically wrong. It makes real benefits and taxes hypersensitive to inflation. The Quadrennial Advisory Council on Social Security that reported in 1975, the Consultant Panel on Social Security that recently reported to the Ways and Means Committee and the Senate Finance Committee, and, as far as I know, all other social security experts believe that the current method of indexing should be corrected. I cannot stress too strongly that this error must be corrected before people come to believe that they are entitled to these impossible

benefits. In my subsequent comments, I will assume that the current double indexing is corrected.

2. The recent demographic swing from baby boom to baby slump will eventually require a very large increase in the social security tax rate if the current relative benefit structure is to be maintained

The effect of this demographic swing will be to reduce the number of workers when the number of retirees is high. Today there are 30 retirees per 100 workers. Forty years from now, there will be 45 retirees per 100 workers, an increase of 50 percent. If the current pattern of benefit replacement ratios (i.e., the ratio of benefits to previous earnings) is to be maintained, the tax rate would also have to rise by 50 percent, to 16 or 17 percent. If productivity growth is less than the 2 percent currently anticipated, the tax rate must rise even further.

As a minimum, such a tax increase would prevent raising other tax revenue for important purposes. And, added to the current marginal tax rates of more than 30 percent already paid by families earning \$10,000 to \$15,000, this extra tax would have substantial disincentive effects.

Although there has been much concern about the social security program's unfunded liability of more than \$2 trillion, there is no economic reason why social security should ever be bankrupt. Current beneficiaries and covered workers are expected to receive over \$2 trillion in benefits more than they are expected to pay in future taxes. If social security were a private pension program, it would require current assets of more than \$2 trillion to be financially solvent, i.e., to guarantee its ability to meet its future obligations. Since the social security program has a trust fund of only \$44 billion, or some 2 percent of its obligations, social security is bankrupt by the conventional standards used to determine the actuarial soundness of private pension programs. This analogy of social security to private pension programs is, however, totally misleading. A private pension program must have sufficient assets to meet all prior commitments because it cannot be certain that any future contributions will be made. In contrast, the government can continue to compel future generations of workers to pay social security taxes. The future tax rates can be set so that tax revenues are sufficient to meet the claims of the beneficiaries. The government's power to tax is its power to meet the obligations of social security to future beneficiaries.

As long as the voters support the social security system, it will be able to pay the benefits that it promises. It is therefore very important to prevent an increase in the tax rate or other changes that will undermine public support of social security's primary purpose: providing income-related annuities that individuals otherwise could not or would not buy for themselves. Maintaining political support will become even more difficult because of the problem to which I now turn.

3. Social security retirees receive on average more in benefits than they (and their employers) paid in taxes during their working years. This excess of benefits over lifetime taxes is equivalent to earning a very high rate of return on the taxes paid. Unfortunately, this rate of return will fall sharply in the future so that social security will provide a much lower rate of return than private investment

A private pension program can give a retiree more in benefits than he previously paid in contributions because the private pension invests in stocks and bonds that pay interest on the individual's contribution. Over the past 25 years, the real annual yield (after adjusting for inflation) was 8 percent for common stocks and 3 percent for corporate bonds. A conservative portfolio with half of each would have yielded 5.5 percent.

Social security can pay more in benefits than the retirees previously paid in taxes for a very different reason. Social security does not invest tax receipts and therefore does not earn real interest or dividends as a private pension plan does. Instead, these tax receipts are paid out to current retirees. The secret of social security's ability to pay back more in benefits is the growth of the social security tax base.

Those who are retired today get more in benefits than they paid in taxes because the current social security tax base of more than \$650 billion is much greater in real value than it was when the current retirees were working. The rapid growth of the real social security tax base that permitted the high rate of return on social security taxes has four separate sources.

(1) Average weekly earnings before tax have grown during the past 25 years at an annual rate of 1.3 percent after adjusting for inflation. If we disregard the recession of 1974 and 1975, the 23 year growth rate was 1.7 percent.

(2) The population over age 16 grew at 1.4 percent per year and the labor force participation rate rose slightly.

(3) The coverage of social security was extended to include new industries, the self-employed and other categories originally excluded.

(4) The tax rate was increased from 2 percent in 1937 to 1949 to 9.9 percent today (with an additional 1.8 percent for the health benefits), to finance higher benefits as well as benefits for the disabled, survivors, etc.

As a result of these four changes, real social security tax receipts for OASDI rose at an annual rate of 10.4 percent during the past 25 years after eliminating the effect of inflation. Stated somewhat differently, these social security taxes were 1.4 percent of total wages and salaries in 1950 but 7.9 percent in 1975, a more than five-fold increase. It was this very rapid growth of tax receipts that made it possible for social security to offer such a "good deal" to participants.

These four sources of growth of social security taxes cannot continue in the future. Fortunately, real wage rates will continue to rise, economists generally expect the past rate of 1.7 percent to be a reasonable indication of what can be expected in the future. But none of the other sources of tax base growth can.

There has already been a dramatic drop in the birth rate. The current birth rate is not sufficient to maintain a constant size of the population. Moreover, the new technology of birth control and the new opportunities for women to work outside the home represent permanent changes that will depress the birth rate even if a change in tastes and attitudes about family size induces some to have larger families. The official government actuaries regard as optimistic a forecast based on the assumption that the birth rate will rise enough to keep the population from shrinking. But population growth will not be a sustained source of growth of social security contributions in the future.

The coverage of social security is now almost universal. Although extension of social security to federal government employees and certain state and local employees who do not now participate would be desirable, it would not add significantly to the growth of the tax base.

Finally, there is no way in which the tax rate can continue to increase to provide richer benefits as it did in the past—a five-fold increase from 2 percent to 10 percent in 25 years. Indeed, even to maintain the current pattern of replacement rates would require an increase of the rate to 15 percent.

When the tax and the population have stabilized, the only source of growth will be the rise in real wage rates. With the full maturity of the social security system, the "rate of return" that participants will earn on their social security contributions will be limited to the growth rate of real wages, at most about 2 percent per year.

This fall in the rate of return will make social security much less of a "good deal" for participants than it was in the past. This in turn will reduce political support for a large social security program. When labor and management see that they can get a much higher return from private pension plans, their support for social security will turn to pressure for a much reduced program that concentrates on providing a more minimal level of benefits.

4. *For many retirees, social security benefits exceed previous income.*

A man who retires in 1976 and who always had median earnings in covered employment (now about \$8,500 a year), will receive benefits equal to 46 percent of his pre-retirement year's gross earnings. If he has a dependent wife, he will receive half again as much or 69 percent of his previous maximum gross earnings. Based on \$8,500 of earnings, benefits would be \$5,865. But the social security benefits are untaxed while the earnings are subject to federal and state income taxes and social security taxes. Since the social security tax alone would be \$500, a conservative estimate of the total tax liability would be \$1,000. The \$5,865 of cash benefits actually replace 78 percent of the previous net earnings of \$7,500. In addition, the beneficiaries also receive Medicare benefits worth more than \$1,000 per aged couple. Because the benefit schedule is progressive, someone whose earnings were below the median would have an even higher replacement rate.

Such high replacement ratios at retirement are inappropriate for middle and higher income couples. Recall that these high replacement ratios mean that the retiree receives from social security alone more than he was able to earn in his

30's, 40's and 50's when he had children to support, a mortgage to pay, etc. Moreover, these social security benefits are often supplemented by private pensions.

It is ironic and sad that social security forces many families to cut their spending even when their income is low and their responsibilities are great in order to have more to spend during retirement when their income is already as high as it has ever been. Reducing the high replacement ratios currently planned for those who will retire at the turn of the century would permit a welcome reduction in the tax rate or, at least, reduce the size of the increase needed to offset the demographic change.

The fall in the rate of return to beneficiaries makes the high replacement rates even more costly. Continuing to follow a policy of such high replacement rates will further weaken the political support of the social security program.

5. The high benefits and the earnings test force many to retire who would otherwise work

It is the rare man who continues to work when he can get more in social security benefits than he can earn by continued work. But even those who can expect less than 100 percent replacement of lost net earnings will often find that the relatively high level of benefits and the small extra income that would result from work make continued work too unattractive. In 1929, 55 percent of men over age 65 were still working while now less than 25 percent continue to work.

Why is such induced retirement a bad thing? Because individuals are forced to contribute to social security throughout their working life and then to forego the benefits to which they are entitled if they do not retire. The strong incentive makes them decide to retire, but they would often be happier if they could have somewhat reduced benefits without retirement, or exchange a lower tax rate for later retirement, or later retirement for a higher level of benefits.

6. Social security does not prevent poverty in old age

The prevention of poverty in old age is now the responsibility of the Supplemental Security Income program that began in 1972. This is a means-tested program financed out of general revenue. SSI paid \$5.5 billion in fiscal year 1975. This was often supplemented by state funds.

SSI is a welcome improvement since social security itself never succeeded in eliminating poverty, especially among widows and older retirees.

7. Two-thirds of American employees are covered by private pensions

Private pension coverage, including the pensions of government employees, has grown rapidly and now covers at least two-thirds of American employees. The percentage is even higher if part-time workers and persons under age 25 are excluded. The new Pension Reform Act recently legislated the vesting of pension rights, established funding obligations, etc.

It would not be too much of an exaggeration to say that every employee who can expect to benefit from social security is also covered directly or indirectly by a private pension plan. Most of the employees not covered by private pension plans are low wage workers who in old age will be supported by SSI rather than by earned social security benefits or wives whose husbands are covered by private pension plans.

Moreover, the tax law encourages what is known as the "integration" of social security and private pension coverage. For example, a firm that contributes 15 percent of earnings to a retirement pension must contribute 15 percent for all employees (after a brief waiting period) but can "integrate" and contribute only the excess of 15 percent over the amount contributed to social security. The firm therefore contributes only \$330 on behalf of someone who earns \$10,000, i.e., 15 percent or \$1,500 minus the \$1,170 social security contribution. With full integration, any change in the social security tax causes an equal and opposite change in the private pension contribution.

8. The lack of progressivity of the payroll tax is irrelevant

The social security payroll tax has been criticized because, unlike the personal income tax, it is not progressive but proportional up to a limit (now \$15,300) and then ceases to increase. It is, however, inappropriate to focus exclusively on this tax instead of seeing it in the context of the entire fiscal system. First, the benefits are progressively related to the taxes so that the social security program

as a whole is progressively redistributed. Second, the federal personal income tax rates can be adjusted to achieve any overall degree of progressivity for middle and upper income taxpayers. Finally, the new rebatable earned income credit can be extended to all low income families in order to offset the burden of the payroll tax to the extent that Congress desires.

9. More than half of married women are now in the labor force

The current labor force participation rate of married women has more than tripled from the 14 percent recorded in 1940. The social security program's treatment of dependent spouses and of working wives was designed for the very different conditions that prevailed in the past.

Under current rules, many working wives pay taxes all their life but receive no more in benefits than they would if they had not worked. Even worse, a couple earning \$8,000 each will pay more in taxes and get less in benefits than a one-earner couple in which the man earns \$10,000.

10. Social security substantially reduces capital accumulation

For most Americans, the social security program is the major form of saving. With social security, it is possible to do little or no saving through bank accounts or private pension plans and still have a high standard of consumption during retirement. Because individuals substitute social security for such private saving, total private saving and private capital accumulation is reduced. Because of our current pay-as-you-go method of financing social security, the tax receipts are paid out as concurrent benefits and are not accumulated. There is no real investment of social security benefits to offset the reduction in private saving and investment. The result is a fall in our nation's rate of saving and in our capital stock.

I believe this fall in saving is very large. The 1975 social security tax receipts of more than \$75 billion were nearly as high as the \$90 billion of personal saving. The fall in our capital stock may exceed \$1 trillion or a reduction of more than 25 percent.

With less capital, there is a lower level of productivity, lower wages and fewer good jobs. By reducing private saving, through social security, we deny ourselves the opportunity to invest with a rate of return to the nation of 15 percent and limit ourselves to the implicit return of only 2 percent that social security will provide in the future.

EIGHT RECOMMENDATIONS

Let me turn now to a set of eight recommendations that deal with the problems raised above.

A. The tax rate should be raised within 3 years to eliminate the short-run deficit

There is no need for an immediate tax rate increase but failure to do so within three years is likely to precipitate a crisis that would long undermine confidence in the system. Whenever the increase occurs, other tax policy should be coordinated to prevent an undesirable macroeconomic effect.

The long-run financial problem that results from the changing demographic structure of the population could also be dealt with by increasing the tax rate from the current 11.7 percent to somewhere between 18 percent and 25 percent. Such an increase would be undesirable and is in fact unnecessary. There are two alternative policies that also deal more effectively with some of the other issues raised above.

B. Index the benefit formula so that future benefits and replacement rates depend on real and not relative income

It has always been a principle of social security that individuals with higher lifetime average earnings and contributions should receive higher benefits. It has also been a principle that the replacement ratio (i.e., the ratio of benefits to pre-retirement earnings) should decline with income. As I noted above, a retiree with a dependent wife who has always had median earnings (now \$8,500) will get benefits that replace 69 percent of his previous gross wage. In contrast, someone who has always had maximum earnings (now \$15,300) will get a lower replacement, about 45 percent including the dependent's benefit.

Thirty years from now, a man who has had median earnings all his life will be earning about \$15,500 (measured in the prices of 1976). I believe that with this increased income it would not be appropriate to continue the 69 percent replacement rate currently given to the median worker with a dependent. This would

produce a benefit of nearly \$11,000. I think it would be more appropriate to recognize that a lower replacement rate is appropriate at that higher real income. Using the benefits that prevail today would imply the 45 percent replacement rate currently used for someone with that income level, or tax-free benefits of \$7,000 a year.

Relating benefits to real income will make benefits rise more slowly than they otherwise would. This method of "real benefit indexing" was advocated by the Consultant Panel on Social Security that recently reported to the Senate Finance and Ways and Means Committees. They estimate that this way of dealing with the double indexing problem can eliminate most of the 5 to 8 percentage-point rise in the tax rate that would otherwise be needed. This occurs because the average replacement ratio generally falls to about 30 percent (plus dependent benefits) instead of the current average of about 45 percent (plus dependent benefits).

Eliminating the current double indexing in this way not only solves most of the financial problems caused by the changing demography but has other advantages as well. It responds appropriately to the reduced rate of return discussed above by reducing the amount that individuals are forced to "invest" at that rate. It eliminates the anomaly by which benefits can exceed previous net earnings and ends the situation in which individuals are forced to pay taxes when their incomes are low to support a more generous standard of living later. Reducing the average replacement ratio for the next generation of retirees will provide a greater incentive for the private saving that leads to national capital accumulation. The widespread private pensions coverage and their regulation by federal rules imply that individuals will have an opportunity to supplement social security in a safe and productive way.

Planning to reduce replacement ratios by slowing the growth of real benefits provides flexibility. If conditions are more favorable than predicted, Congress can raise both taxes and benefits.

C. Develop a larger social security capital fund

Indexing to make future benefits depend on real income will not in itself completely eliminate the need for increased rates in the future when the ratio of retirees to workers is substantially higher. We are therefore asking the next generation to pay an increased rate of tax to support us as retirees even as the whole social security program becomes less of a "good deal" for them than it has been for us. Such an unfair shifting of the tax burden to the next generation clearly runs the risk that they will refuse to pay and thus face a lower level of benefits than future retirees currently expect.

To prevent this, we should raise taxes during the next decade by more than is required to meet the current benefit obligations. This would provide a surplus that could be accumulated in anticipation of the demographic bulge ahead. A 2 percent addition to the tax rate would produce about \$15 billion a year at current income levels. The income of this fund would be available to pay for the extra benefits when the demographic structure changes.

Such a capital fund would be desirable for other reasons as well. By using the added fund to buy outstanding government debt, social security would add to the nation's rate of saving. A surplus of \$15 billion corresponds to the added savings that Duesenberry and Bosworth recently proposed in a study for the Brookings Institution. Because social security is seen as a social alternative to private savings, it is politically appropriate that such a fund be accumulated by social security. Since the real yield that society earned on such a fund would exceed the 2 percent "rate of return" available in a mature social security system, it is an efficient way to finance future benefits.

I have discussed the idea of a social security fund at length elsewhere; I am submitting a brief statement drawn from an article in the *Public Interest* (Summer 1975) for subsequent analysis by yourselves and your staff.

D. Reform the treatment of two-earner families and of dependent wives

The current system is widely regarded as unfair by working wives who pay full taxes for little or no extra benefits. There are several options for treating working couples as a single unit. These deserve more attention than I can give them here.

Restructuring the treatment of two-earner families and of dependent wives would not only be equitable but would eliminate the advance work incentive that follows from imposing a tax of nearly 12 percent on a working wife and giving little or nothing in return.

E. Relax the earnings test

One of the most frequent complaints of older people is that they are forced to retire in order to get benefits. In a society in which most retirement is voluntary, this is seen as unfair and is in fact a misuse of resources.

Individuals who would prefer to work until 70 are forced both to pay taxes to finance benefits at age 65 and then to forego those benefits if they continue working or to retire earlier than they would otherwise choose. Several remedies exist: eliminate the earnings test completely, increase benefits actuarially with late retirement, provide some benefits to everyone at age 65, etc.

The argument that this cannot be done because it is "too expensive" is not valid. The estimates of the cost focus on the payment of social security benefits and ignore the gain in federal income tax receipts and in personal net income.

F. Raise SSI benefits

The federal standard for SSI is still very low, less than \$3,000 a year for a couple and less than \$2,000 for an individual. I believe we should spend more to eradicate the poverty of these older people. The danger of an adverse work incentive is less than it would be with younger people of working age. And the problem will be self-correcting as future social security benefit levels raise more of the aged out of poverty.

This is a group that I believe is particularly deserving of your attention: those who received social security benefits before benefits began in 1972 to be adjusted for changes in the paid level. Older retirees (over 75) and women who became widowed many years ago could be singled out to have their benefits raised from general revenue by a special extension of SSI.

G. Tighten the relation of benefits to previous contributions

Most Americans regard their so-called social security "contribution" as a tax that entitles them to receive future benefits but that is not at all closely related, to the amount of those benefits. When a man or woman earns \$5 an hour and has a take-home pay of \$4 an hour, he regards the difference as a tax and doesn't take into account the nearly 60 cents that is being "contributed" to social security. With the current treatment of working wives and of dependent wives, with the retirement earnings test, with the progressivity of the benefit schedule, with the imperfect indexing and the disregard for the timing of contributions, these taxpayers are quite right to view social security as essentially a tax.

That perception and the reality that it represents is unfortunate. It makes the social security "tax" a very important source of work disincentive. For most families, the social security tax is more than the personal income tax. This 12 percent tax on top of federal and state income taxes moves the marginal tax rate from one-fifth of additional earnings to one-third. And when taxes take one-third of extra earnings, there is bound to be an effect on such things as work effort, job choice, the willingness to get additional training to relocate, etc.

In addition to these adverse incentives, the weak connection of benefits and taxes creates a sense of unfairness that can undermine support of the entire program.

We now have the ingredients with which to link benefits directly to previous contributions for all but the very poorest. Benefits are set by accumulating individual contributions expressed in dollars of constant purchasing power. Benefits are available without retirement or are actuarially increased for later retirees. Two-earner families are not required to pay disproportionately more in taxes than they receive in benefits. The low benefits for those with low lifetime earnings are supplemented by more generous SSI and the progressivity for higher income workers is adjusted through the personal income tax. The result is a system that is more equitable, politically stronger and economically more efficient.

H. Do not raise the relative maximum taxable earnings

The maximum taxable earnings are now \$15,300. Approximately 85 percent of covered workers have earnings below this level. The current plan is to increase the maximum taxable earnings as wage rates rise but to maintain the same 85 percent ratio.

There are occasional suggestions that this ceiling be raised as a way of generating extra revenue for the social security program. In the short run, some extra revenue is obtained because additional taxes are received before any sub-

stantial number of retirees can collect extra benefits. In the longer run, there is a revenue gain because of the current progressivity of the benefit structure.

These gains in revenue are small when compared to the disadvantages. Almost all of the extra tax revenue can be expected to come out of saving. This further reduces our nation's potential rate of investment. It foregoes a chance for high yielding real investment (which itself generates substantial corporate income taxes) to obtain the low "return" provided by social security. The 1977 maximum is expected to be \$16,500; raising it to \$18,900 would cover 90 percent of wages but would reduce saving by as much as \$5 billion.

Of course, if the link between benefits and taxes were properly tightened there would be no long-run gain in net revenue for the system but there would be a permanent reduction in saving.

Let me end on a more general note. The best features of our current social security program were designed 40 years ago under very different economic and social conditions. It is important that we reexamine the structure of the program. Only if our loyalty is focused on the purpose of the social security program rather than its current form can it be revised and updated to strengthen its good features while reducing or eliminating some of its harmful effects.

Attachment.

A SOCIAL SECURITY FUND¹

It is clear that our current pay-as-you-go social security program has certain grave side effects: a substantially lower level of national income, and a redistribution of income from wage and salary earnings to the owners of capital. What can be done to correct these harmful effects without losing the advantages of the current social security system? I pose the question in this way to emphasize my disagreement with some radical reformers who would abolish our social security system, on the grounds that it interferes with each individual's freedom to decide how much to save for his old age. The abolition of social security would be inconsistent with our nation's commitment to prevent poverty during old age. Although social security might be replaced by a system of means-tested grants to older persons who have neither the income nor the wealth to be self-sufficient, I believe that this would be a self-defeating policy. If the level of benefits were set high enough to provide what would generally be regarded as an adequate standard of living, the new program would be a substantial incentive to workers not to provide for their old age. The means-tested benefits would thus have the double disadvantage of discouraging savings and lowering the real income of the aged.

How then should the current social security program be reformed to reduce the harmful effects on capital accumulation? And can this be done without the public hostility and political opposition that might be aroused by a major restructuring of the benefits? Fortunately, it is possible to alleviate the problem without making any changes in the structure of the program that would be noted by the general public. The problem of reduced capital accumulation arises because the government pays out all social security contributions as they are received, and thus does nothing to offset the fall in savings by households. If a substantial portion of social security taxes were instead saved and invested by the government, as they would be in a private pension program, the social security system would accumulate its own reserves, which would offset the reduction in private capital accumulation. Stated somewhat differently, the social security program, by collecting more in taxes each year than it paid in benefits, would add to the national rate of saving and would thus partially offset the reduction that it causes in the private savings rate.

Let me emphasize that I am not arguing that a large social security fund is necessary to protect the actuarial soundness of the social security program. I explained earlier that the social security program does not need a reserve fund in order to pay future benefits. The power to tax the earnings of future workers makes traditional actuarial soundness irrelevant. But the fact that a social security fund is not indispensable does not make it any less desirable. Such a fund would increase the level of income, raise wage rates, and lower the cost of capital. The benefits from the fund in the form of higher future consumption would be well worth the current sacrifice. Economic studies indicate that society would

¹ This is taken from "Toward a Reform of Social Security" which appeared in *The Public Interest*, Number 40, Summer 1975.

earn a real rate of return of 15 percent on additional capital accumulation.² A \$100 investment now would yield the nation an additional \$15 of real goods and services in every future year. This higher income could be used to reduce the future growth of taxes, leaving more for personal consumption and investment.

I have learned from experience that proposals for the establishment of a large social security trust fund are often met with various incorrect objections. I will discuss the five arguments that I have heard most frequently:

1. It is often alleged that accumulating a social security fund would not add to real capital accumulation. Nancy Tetters, now a senior Congressional budget analyst, provides a very clear statement of this view:

A private pension plan can transfer resources over time for the individual by currently investing in productive capital that produces real income in the future, whereas the social security surpluses are invested in government securities. The interest on those government securities is a government expenditure that must be financed from current revenues. Creating near-term surpluses to build up large trust funds that will generate large interest payments in the future does not reduce the burden of supporting the dependent population in the year that it occurs. The existence of large trust funds only determines whether the cash-benefits program is going to be financed out of payroll taxes or out of general revenues used to pay the interest on the securities held by the trust fund.

There are two common and crucial errors in this paragraph. Consider what actually happens when the social security program has a surplus with which it buys outstanding government securities on the open market. First, the future interest payments on that debt are paid to the social security program instead of to the private individuals who previously owned the government bonds. Therefore, contrary to the implication of Dr Tetters' statement, there is no need for additional general taxation to make extra interest payments. And the social security program has interest income that permits it to lower the payroll tax and yet still provide the same level of benefits. The burden on the future generation of taxpayers is thus lighter. Second, the private individuals who originally sold their government bonds to the social security fund will invest the proceeds in private bonds and stocks.³ This additional demand for private securities will increase the funds available for private investment, and extra private investment increases the real capital stock and raises future income. In this very real sense, a social security trust fund can transfer resources over time and reduce the tax burden on future generations.⁴

2. There is still a vestige of the early Keynesian fears that a social security surplus would produce excess savings and serious recession.⁵ These concerns have inappropriately been carried from the Great Depression into the present decade. Now our capital market would have no difficulty in adjusting to an increasing rate of savings. With more capital available for investment, the cost of capital would fall; firms would introduce more capital-intensive techniques of production, and would provide more good jobs in capital-intensive industries. There is no reason why the United States cannot absorb savings at the same high rates that other developed countries can.

3. Some who would otherwise favor an increase in capital accumulation fear the excessive interference of a social security fund with the private economy. There would be grounds for such concern if the accumulation of a social security fund required ownership of physical capital or equity shares in private companies; however, such investments are not necessary. There is currently more

² A 15 percent real rate of return may seem unlikely because it is so much higher than most individuals are able to earn. It must be remembered, however, that the individual's return is reduced by the corporation tax and the personal income tax, and may be limited by regulations on bank interest rates. The real return to society includes the taxes received by the government as well as the net income received by the investor. The ratio of before-tax corporate earnings to share prices provides a rough measure of the potential social return on additional investment; for major industrial companies, this now exceeds 15 percent.

³ This assumes that the government does not undo the achievement of the social security fund by increasing its general deficit.

⁴ If some portion of these extra private funds is invested abroad or replaces foreign investment in the United States, the social rate of return on them may be lower than otherwise. This occurs when a foreign government collects part of the return in its business income tax, or when the United States loses corporate tax receipts on displaced foreign investment. But the additional investment still transfers resources over time in a productive way and thus alleviates the burden on future generations.

⁵ In 1941, Seymour Harris, one of the pioneer Keynesians in America, praised the ability of the social security program to reduce total saving.

than \$500 billion of privately held government debt (including the debt of state and local governments) and more than \$200 billion of additional bonds issued or guaranteed by government agencies. Private mortgages and corporate bonds provide further means for channeling funds to the private capital market without becoming involved in management or equity ownership.

4. Accumulating a surplus in the near term requires raising the social security tax rate. This is seen by some as unfair or excessively burdensome. It must be remembered, however, that the social security tax is already scheduled to increase substantially in the future in order to deal with the changing demographic structure of the population. By raising the tax rate now, the eventual total increase can be reduced, since the interest income of the social security fund will be available to pay part of the cost of future benefits. If we do not raise the tax rate now, we will be placing an unfair burden on the next generation—asking them to pay a much higher tax rate to support us than the rate that we charged ourselves. And if they refuse to shoulder this burden, and to tax themselves more heavily than we are now taxing ourselves, the benefits that we receive will be very much smaller than we now expect.⁶

5. Finally, there are some critics who object to lodging such a fund in the social security agency rather than in the Treasury or in some other government department. I recognize that there is no compelling economic logic for assigning this responsibility to social security. But historically and politically, the social security system has been viewed as a substitute for private savings and private pensions. The social security agency is therefore the natural place in the government structure in which to locate a public savings or pension fund. Adding to the already existing social security fund should raise none of the ideological or political objections that might be aroused by the creation of a new government investment agency. It is not just coincidence that in other countries the ownership of a large public capital funds has been specifically vested in the social security agency.

Representative BOLLING. Thank you, Mr. Feldstein, and you all for some very stimulating statements. I am more and more convinced as I listen today as I have studied the question and other questions relating that the fundamental dilemma in all of this is probably going to turn out to be something that is a very complicated kind of politics. We are going to have to figure out a way to get a series of tradeoffs, political tradeoffs and within a very large frame of reference in order to be able to do any of the detailed things that I think we can probably get a consensus on are desirable.

But I will come to that second. Mrs. Rivlin, during 1974, the first year of the SSI, the administration cost of that program was only 2.1 cents out of every Social Security Administration dollar. Do you know how much the cost is today?

I am told that the SSI administration costs have gone through the roof and are not truly reflected in the budget figures.

Mrs. RIVLIN. I don't know the exact answer to that, Mr. Bolling, although I would be glad to look into it and provide an answer for the record. It is certainly true that the cost and difficulty of administering the SSI program has been a surprise to everyone.

It was not anticipated that it would be this complicated and difficult or this expensive.

Representative BOLLING. Anybody want to comment on that? I think—I would like to have you submit something for the record because I think that is a very pertinent problem.

⁶ Recall that the tax is currently forecast to rise eventually by between six percentage points and 10 points just to compensate for the changing demographic structure. Increasing the tax now by four percentage points would yield an investable surplus of nearly \$30 billion in the first year. The accumulating fund that results from such an increase might be sufficient to make all future increases unnecessary; an actual estimate of the increase required to establish such a permanent stable rate remains to be done.

Mrs. RIVLIN. If I might jump in on that one, not to support the proposal entirely, but to note that it would be simpler to give everybody a flat amount. That is a very easy program to administer, easier than to try to do what we are now undertaking.

[The following information was subsequently supplied for the record:]

The estimates of the cost of administering the SSI program in fiscal year 1976 as included in the President's Budget is 20% of the total administrative costs of the Social Security Administration or about \$493 million out of \$2.3 billion. The General Accounting Office is undertaking a major review of the impact of the SSI administrative burden at the request of the oversight subcommittee of the House Ways and Means Committee to see if the burden is adequately covered by the estimated costs.

Some additional background information may be helpful in connection with your question.

Although the Supplemental Security Income program (SSI) is administered by the Social Security Administration (SSA), it is funded separately by annual appropriation from the general fund.

The SSI program is a public assistance program providing financial assistance to aged, blind and disabled persons on the basis of a means test. It is federally funded and is supplemented by state payments under certain provisions of law.

Structurally and organizationally the SSI program is housed within SSA because of its broad interaction with the social security program. Staff of SSA in the district offices are also staff of the SSI programs. A person seeking assistance for SSI is also assisted for the purpose of SSA. Functionally, and in terms of mission, the programs are separate and costs are accounted for separately. The funds for the cost of SSI are paid to the SSA trust funds so that the integrity of the social security funds are maintained.

It is true that SSI costs are very much higher than were anticipated when the program began. There are two fundamental reasons for this. First, the program has been amended to achieve certain objectives that were not clearly foreseen earlier. For example, certain tests of eligibility and income, were added to the program after its enactment. Secondly, the program began in 1974 at full speed with little or no time for testing the operations and procedures and there have been administrative difficulties which have been costly to overcome.

The effect of both of these factors has been to place a heavy burden on the SSA machinery and staff and a consequent drag on the service normally provided to SSA clients. Processing time for both SSI and SSA has suffered and allegations have been made that the true cost of SSI is not accurately reflected in the formal reports.

Mr. FELDSTEIN. While that is true, that it is easier to send everybody a check for \$1,200 a year, with the current population of older people we are talking about more than \$25 billion while the current program is paying out \$5.5 billion.

We are talking about a program that is five times as expensive and yet a program that does not take people out of poverty. Sending a couple \$2,400 a year is not going to lift them out of poverty. You need to have a more generous lump-sum grant to achieve the deviation of poverty.

I would rather I think face the extra administrative cost of the means tested program than to have all the real economic costs associated with raising yet another \$30 billion or \$40 billion of general revenue to provide a lump sum grant for everyone.

Mr. TLOVE. The proposal or the suggestion of a possibility of a grant of \$1,200 a year is not intended as a complete substitution for supplemental security income although it would serve in large measure to do that.

But offsetting the rather large costs is the fact that I advance it as a possible substitute for the spouse benefit, for the weighting of the social security formula, and for other aspects now incorporated in social security cost.

Representative BOLLING. I think it might be more productive if I got your permission, all of you, to have the staff submit some questions to you after this hearing. It is very obvious to me that at some time in the future we are all going to have to have—we and others—are going to have to have a more extended discussion than we are going to be able to have today.

The first step is to get some detailed answers from you. If you don't mind I propose that that be done. What I would like to do in the time that I have remaining and the time that we have allotted, I would like to see if I am anywhere near, in your opinion, the right approach to the overall problem of which this is a part.

It seems to me that the whole complexion of matters that the Congress and the administration have been talking about but unable to deal with in a legislative and political sense which include the whole question of health insurance, the reform of welfare, the whole problem of the less-well-understood aspects of income maintenance, social security, unemployment compensation, a whole range of these things are so much related to a very obvious thing and that is the general health of the economy, that it has arrived at a time where this country has to begin to look at the overall problem as it looks at each of these major problems.

I don't see how politicians—I am not talking about people who study this form an actuarial point of view or any other point of view—I don't see how politicians are going to be able to arrive at a rational trade off unless we are looking very much at the overall in terms of the economy. Mrs. Rivlin's testimony makes it very clear how much this particular relatively narrow field—relatively only in a specific sense—depends on what happens with the economy.

I am told that in the delivery of health care that the standard figures on what inflation is and the economy generally are doubled or tripled and there is some argument as to whether they are doubled or tripled, that if the inflation and the cost of health delivery, the delivery of health care continues, that the whole current situation will be drastically changed.

Politically, you have this murderously difficult problem of the two perspectives of welfare and Mrs. Griffith's extensive study in the last Congress which has not been acted on in any real way makes it very clear that the present welfare income maintenance system is grossly unfair at both ends.

It is unfair to the taxpayers and it is unfair to the people who should be receiving income maintenance because some of them get missed. You go on and on and on piling these problems, each of which has to be studied separately but each of which has to be looked at in context.

I wondered if we are not at the point where in order to have any hope of reasonable solutions, not on this particular one, but this one related to all the others, and one of the sides of the issue of the delivery of health care is the one that wants to relate it to the social security system, are we not going to have to begin to look at an overall approach

to the economy which will be more severe and much more difficult than anything we have done so far?

I am talking about something as innocent as what we are beginning to do, that is, the discussion of whether we should not try to have a real full employment country. Isn't this related?

Mr. FELDSTEIN. A little bit in the short run. I like your approach of saying we have to look at all these programs together. You can't talk about medicare and medicaid without looking at unemployment insurance and welfare at the same time. I am with you there. It is also true that in the short run the economy does affect the size of these programs, not just for unemployment insurance but also for retirement and welfare.

But I think that these problems we are talking about today are problems that are going to last into the next 50 years. The exact fluctuations of unemployment, whether it is 5 percent or 3 percent or 7 percent is not going to have a dramatic effect on the kinds of problems we are talking about here. It is important to avoid the brief that these problems would be somehow solved or substantially alleviated if only we had the 3 percent unemployment rate and a low general rate of inflation.

I don't think that is true, unfortunately.

Representative BOLLING. Why is that not true?

Mr. FELDSTEIN. Because the problem of social security financing in the long run, once you have corrected this indexing problem, will be made independent of the rate of inflation. The amount of benefits will depend not on the rate of inflation and the level of prices at all.

Social security will become more costly because there will be many more retirees and fewer workers in the year 2020 than there are today.

Representative BOLLING. The thing that intrigues me about that—and I don't want to get into a completely abstract conversation which I could easily do—is that I suspect the demography would be changed if the expectations of people were changed in terms of my ghetto in Kansas City, Mo.

I suspect that the attitude toward education would be changed if a great many of the people in my inner city felt that there was some possibility that they not only might have a job but might have a career.

I don't want to raise the ante so high that we end up in very abstract philosophical discussion but it seems to me that somehow these things really are related if you look at them that way.

Mr. FELDSTEIN. Everything is related to everything in the economy but I think you are not going to solve the social security problem by getting the unemployment rate down.

The problem of the ghetto youth who are currently unemployed is not going to be solved by tightening up labor markets in general.

To that extent, we want to broaden the definition of what we are doing to include programs that help people get jobs and find better jobs.

Mr. TLOVE. I am not sure I agree with Mr. Feldstein. In the short run, you will notice that the trustees' projection sort of assumes 5 percent as a minimum unemployment rate which may be subject to some question. But let's take the long run.

Part of the problem is we had a baby boom for 20 years followed

by lower fertility rates amounting to zero population growth or less. The real question to ask is this: Zero population growth was supposed to hold out the prospect of a more prosperous country, not a less prosperous country.

The real question is: Is it correct that with zero population growth, the generation which represents the baby boom will have to settle for a lesser percentage of income in retirement than was true of earlier generations?

Forget money. Let's talk about a country which will be in the favored position of having controlled its population growth. Will that country be unable to support its then existing rather stabilized population whether working or not in a relationship to previous earnings that is less favorable in the future than it was in the past?

Offhand I can't quite accept the overall concept that having achieved the desirable goal of controlling population we will have to face the consequences of tightening belts for some portion of the population later on.

One additional comment which struck me only recently and rather peculiarly. This generation which is the baby boom may in time get to be known not as the lost generation perhaps but as the overcrowded generation. Perhaps a large part of the unemployment we have today comes from the failure of the economy to provide jobs to the very people who are the ones we are talking about as retiring in the year 2010.

This is a generation which may have gone through overcrowded school rooms and created a higher tax burden for school taxes, then later approached the labor market at a most difficult time and then went through an overcrowded labor market through all its life and overcrowded high ranks in industry, whether it is seniority or managerial positions, only to retire at lesser replacement ratios.

It reminded me of the story of the man in the generation who never had white chicken, which he preferred, because he grew up in the old-fashioned household where daddy took the best. So he had the dark meat. When he grew up and became a father, it was a child centered time and the child had the first choice so he had the dark meat all over again. [Laughter.]

Mrs. RIVLIN. I think Mr. Feldstein is reminding us, and properly, that, even if we were to solve the problems of high unemployment and high inflation, there would still be structural difficulties, such as the legacy of the baby boom to be thought about. That is right. But I would like to change the emphasis: Many of the problems which seem so difficult now such as what to do about unemployment insurance, what to do about the Federal budget, health insurance, are very much complicated and made difficult by the facts that we have an economy which is running well below its capacity and a high inflation rate.

The Federal deficit would disappear if we went back to the full employment with current tax rates. The health problem would be greatly mitigated if we did not have to worry about how we were going to pay not only for any new system but for the cost of the current programs.

With the caveats that Mr. Feldstein quite properly reminds us of, I would like to associate myself more strongly with your point of view. It would be greatly helped if we could get back to full employment and lower the inflation rate.

Mr. FELDSTEIN. It is hard to argue with that proposition. It would be nice if the weather were always better in Boston. But I don't know that that has much to do with social security.

I don't think Mrs. Rivlin and I disagree. I think we both agree that with 4 percent unemployment, a payroll tax of about 20 percent would maintain current replacement rates in the year 2020 and that 20 percent would not be very different if the unemployment rate were 5 or 3 percent. Is that also your view?

Mrs. RIVLIN. Well—

Mr. FELDSTEIN. I think we agree about that. I think it is not a goal which will carry over substantial benefits for social security. Let me make one further comment on Mr. Tilove's proposition.

Talking about lower replacement rates for the future does not mean lower benefits. Benefits are going to rise in real terms. Belts will be loosened, not tightened. The question is, how rapidly they should be loosened?

Today's median income worker makes \$8,500. With a half a working wife, family income is \$13,000. That will go up by a factor of two in the next 45 years. The median worker can now expect, at today's prices, to be making \$17,000. Today we require a two-thirds replacement rate to give him \$5,900. Then a 50-percent replacement rate will give him \$8,500.

He can be better off even though we have reduced replacement rates and the reason for this is not that we are not going to be a more affluent society but because we are, it is not necessary to replace such a high fraction especially when the cost of doing it is a very high tax rate.

Representative BOLLING. I am afraid that unless you have some further comments of your own, I am going to have to bring this very interesting exercise to a temporary close. I am sure that we will pursue it at a later date.

In the meantime, we are very grateful to you and we will impose on you by sending you some questions. We will ask you to give us a reply.

[The following information was subsequently supplied for the record:]

RESPONSE OF HON. ALICE M. RIVLIN TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE BOLLING

(1) Commissioner Cardwell compared the Social Security Administration and CBO estimates of the financial status of the OASDI funds as follows:

"Although there are slight differences between the Trustees' intermediate assumptions and what we understand to be the CBO's latest assumptions . . . the point to be made—and I would like to emphasize it—is that when arrayed along side each other, these two estimates produce essentially the same end result as of 1981. They reach essentially the same conclusion, that unless additional revenue is developed, or unless the benefit structure were to be revised, the funds would be depleted by about that time."

Do you agree with Commissioner Cardwell's statement, or do you feel that there are some important differences in the estimates? If so, please explain.

(2) In the OASDI Trustees' Report this year, certain key economic assumptions have changed from last year. These changes all worked in the direction of making the long-range outlook more pessimistic. First, the fertility assumption was lowered from 2.1 to 1.9, and second the real wage or productivity assumption was lowered from 2 percent annual growth to 1½ percent annual growth. In your judgment is there any special reason to cause these key assumptions to be changed since last year? Do you regard the fertility and real wage assumptions used by the Trustees as reasonable and appropriate?

CONGRESS OF THE UNITED STATES,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., July 21, 1976.

Mr. DOUG LEE,
Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR DOUG: Thank you for your letter of June 18. This note provides my response to the two questions you asked regarding my testimony before the JEC on May 27.

With regard to the HEW and CBO short range estimates on the financial condition of the social security trust funds, there are, in fact, significant differences. Because the differences are not apparent when the OASI fund and the DI fund are aggregated together, we discussed them separately in our testimony. Tables I and II from our testimony, which are attached, show the following:

OASI: The CBO estimate for OASI indicates that the fund at the end of fiscal year 1981 will have a balance of \$31.4 billion. This is more than \$8 billion higher than the HEW estimate for the same period.

The reasons for the \$8 billion difference are the varying assumptions made by CBO and HEW about future wage and price behavior. CBO assumed a larger difference in covered wages over price increases than HEW for the period 1979-81. The data provided below show the different covered wage and price increase assumptions for 1979 through 1981.

	Covered wage growth in excess of price increases (percent)		
	1979	1980	1981
HEW estimate.....	3.0	2.7	2.2
CBO estimate.....	3.3	3.1	3.1

As a result of the more optimistic assumptions, the annual deficits projected by CBO were smaller.

DI: The costs in the DI program are rising faster than earlier predictions. Because the reasons for this are not yet fully understood, CBO simply projected past trends. The HEW estimates dampened the present growth rate. This appears to be an intuitive judgment based on the assumption that the system cannot continue to grow at past rates, or that some tighter controls will be placed on eligibility.

Concerning the economic and demographic assumptions cited in the 1975 and 1976 Trustee's Reports, it should first be noted that these are "ultimate" rates of fertility, prices and real wages. We have not independently projected these factors for the next 75 years and, therefore, can only provide comments on their approach.

A comparison of the 1975 and 1976 cost estimates for OASI by 25 years intervals reveals that the higher 1976 estimate resulted mainly because of higher costs between 2025 and 2050. Forecasts of cost increases that begin 50 years away are highly speculative as they are made from recent trends. Since there are no new facts that have emerged between the publication of the 1975 and the 1976 reports to provoke such a change, we can only assume that the change was based on a reassessment of previous evidence.

The table below shows the difference between the 1975 and the 1976 reports with respect to costs (as a percent of taxable payroll) for the next 75 years by 25 years periods.

	1975 report	1976 report	Difference
1975 to 2000.....	11.64	11.81	+0.17
2000 to 2025.....	16.53	17.95	+1.42
2025 to 2050.....	22.93	27.04	+4.11
Average.....	17.04	18.93	+1.89

Sincerely yours,

ALICE M. RIVLIN,
Director.

Enclosure:

TABLE I.—COMPARISON OF HEW PROJECTION (MODERATE PATH) AND CBO PROJECTION (PATH C) OF THE PROGRESS OF THE OASI AND DI TRUST FUNDS, 1976-81 FISCAL YEARS

	1976	TQ	1977	1978	1979	1980	1981
OASI							
HEW projection: Economic assumptions (calendar year):							
Annual increase in wages (subject to social security tax).....	\$77		\$8.5	\$9.4	\$8.5	\$7.7	\$6.7
Annual increase in prices.....	\$63		\$6.0	\$6.0	\$5.5	\$5.0	\$4.5
Rate of unemployment.....	7.7		6.9	6.6	6.2	5.7	5.2
Maximum taxable wage.....	\$15,300		\$16,500	\$17,700	\$19,200	\$21,000	\$22,800
Total income.....	\$62.4	\$16.6	\$71.8	\$79.1	\$87.2	\$95.6	\$103.3
Total outgo.....	64.2	17.2	73.4	81.5	89.7	98.7	108.0
Net increase.....	-\$1.8	-.6	-\$1.6	-\$2.4	-\$2.5	-\$3.1	-\$4.7
Reserve, end of year.....	38.1	37.5	35.9	33.5	31.0	27.9	23.2
CBO projection: Economic assumptions (calendar year):							
Annual increase in wages (subject to tax).....	\$7.0		\$8.0	\$8.0	\$8.3	\$8.1	\$8.1
Annual increase in prices.....	\$6.3		\$5.5	\$5.0	\$5.0	\$5.0	\$5.0
Rate of unemployment.....	7.4		6.6	6.6	6.0	5.5	5.0
Maximum taxable wage.....	\$15,300		\$16,500	\$17,700	\$19,200	\$20,700	\$22,500
Total income.....	\$62.5	16.7	\$71.7	\$78.7	\$86.4	\$95.1	\$102.9
Total outgo.....	64.4	16.8	73.8	80.3	87.5	95.4	104.3
Net increase.....	-\$1.9	-.1	-\$2.1	-\$1.6	-\$1.1	-\$3	-\$1.4
Reserve, end of year.....	38.0	37.9	35.8	34.2	33.1	32.8	31.4
HEW projection:							
Total income.....	\$8.4	\$2.2	\$9.5	\$10.7	\$11.8	\$12.8	\$14.6
Total outgo.....	9.6	2.7	11.3	12.9	14.5	16.4	18.3
Net increase.....	-1.2	-.5	-1.8	-2.2	-2.7	-3.6	-3.7
Reserve, end of year.....	7.0	6.5	4.7	2.5	-.2	-3.8	-7.2
CBO projection:							
Total income.....	8.3	2.2	9.4	10.6	11.6	12.7	14.5
Total outgo.....	9.6	2.7	11.9	13.9	16.4	18.0	20.7
Net increase.....	-1.3	-.5	-2.5	-3.3	-4.8	-5.3	-6.2
Reserve, end of year.....	6.9	6.4	3.9	.6	-4.2	-9.5	-15.7

¹ The sharp increase in deficit results from a decline in tax rate as 0.1 percent of taxable payroll is shifted from OASI to DI under current law.

² Fund has no authority to go into a negative balance. These figures are demonstrative of what would happen if the fund were to borrow at prevailing interest rates.

Representative BOLLING. The committee stands adjourned.

[Whereupon, at 11:54 a.m., the committee adjourned, subject to the call of the Chair.]

[The following letter was subsequently supplied for the record by Representative Heckler:]

PENOBSCOT CAPITAL INVESTMENT Co.,
Boston, Mass., April 5, 1976.

Senator EDWARD W. BROOKE,
U.S. Senate,
Washington, D.C.

DEAR ED: You're getting pretty formal after all these years, by addressing me in your letter of March 8th as "Mr. Clapp". After all I have known you, as did my mother, before you became a politician. But as to your letter, I have given it a lot of thought, thus my delayed answer.

First, as to Social Security itself:

1. The Secretary of the Treasury, on June 30, 1974, said that Social Security is unfunded to the tune of \$2.4 trillion. So are many private pension funds (more or less unfunded), but nowhere near to this extent, and many are fully funded. Some major corporations could not fund their pension plans without going into bankruptcy. The Commonwealth of Massachusetts also, I think, is not funded at all, but I am not sure of this.

2. The growth of Social Security and private pension plans are already beginning to adversely effect Capital Formation—so important to the growth of the United States.

3. Social Security is actually unsound and getting worse.

4. Social Security now dominates the retirement system with yearly expenses of \$70 billion. Payroll taxes to support this amount to about 40% of all federal taxes on individuals. 23.4% of federal revenues come from Social Security taxes.

5. Pension costs may be a major cause of New York City's financial difficulties.

6. At present, three people have to work to support one retiree.

7. Benefits are awarded on the presumption people stay married to the same person all their lives—this is no longer true.

8. Inflation, caused chiefly by Congress, is a major problem. Benefits exceeded income by about 1 billion in 1975 and by 1977 will probably exceed 8 billion.

9. Social, economic and political pressures have escalated benefits unrealistically.

10. Actuarial assumptions by the Social Security Administration were and are too high. Less babies are being born. Older people are living longer.

11. The Government uses our taxes to pay our parents benefits. Our children and grandchildren will pay for mine.

12. In 1972, more than one-half of all persons receiving Social Security were less than 65 years old. This is ridiculous!

13. The disability definition under Social Security is too liberal.

14. Benefits are too high to be supported realistically.

15. Three cities in California—San Jose, Santa Cruz and Santa Maria have withdrawn from the Social Security System. They have all saved money and improved their pension plans—the proof of the pudding!

POSSIBLE SOLUTIONS

1. Throw the Social Security System out. Of course, this is unrealistic socially or politically.

2. Widowers are now receiving the same benefits as widows. This should be stopped.

3. Social Security should be put on a sound actuarial assumption basis. Congress should authorize an independent actuarial study of the entire system.

4. The "Escalator" provision should be eliminated.

5. A ceiling should be set on the tax or future benefits. As retired people by 2010 will exceed workers, the answer here is obvious.

6. Do something about the particularly heavy burden on all wage earners with annual incomes of less than \$15,000.

7. The tax (Social Security) is regressive! As presently levied, the tax as measured as a percent of total wages do not apply equally to all employees. The more one earns, the smaller the percent of his earnings.

8. Eligibility requirement should be changed. (a) Make women wait to 65 (like men) to receive benefits. This is now illogical, as women outlive men.

9. A better relationship must be established between contributions made and the full years of services credited, in order to make the system self-supporting.

10. In some wage brackets, benefits may nearly equal the average monthly wage. This is obviously ridiculous. In some of the lower wage brackets, the benefits actually exceed the average monthly wage.

11. The law should, at the least, be amended to provide for mandatory integration of Social Security with private pension plans.

12. If a person works for more than one employer, employers as well as employees should be able to claim a refund for excess Social Security taxes paid.

13. The law should be amended to provide for better administration of the funds paid into the system, with public accounting of investment income from these funds. An ideal solution would be to have the entire plan administered by an Independent Board of Trustees accountable to the appropriate Congressional Committee.

14. At present, there is no ceiling on the amount of the annual Social Security cost-of-living increase. It would be desirable to impose a top limit of say 5 percent on these increases.

15. Social Security should not be given to people who have never worked.

16. It would seem desirable to fix a top limit for average earnings for benefit purposes—say \$12,000.

17. The overlap between Social Security benefits for disability and Workmen's Compensation should be eliminated.

18. People are living longer and younger people marry later and have smaller families. Thus zero unemployment at some time in the future is a dim possibility, after eliminating the lazy and the incompetent and the not physically able. Thus maybe by easy steps, retirement age should be increased, and not decreased, to 66, 67, 68 or maybe even 70. This would certainly ease the burdens on the young and our Country.

To try to keep this short was impossible, and I apologize for its length. But there is plenty here to chew on.

I appreciate your desire for helpful suggestions.

Cordially,

EUGENE H. CLAPP II.



837

95th Congress }
1st Session }

JOINT COMMITTEE PRINT

ISSUES AT THE SUMMIT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

together with

ADDITIONAL AND SUPPLEMENTARY VIEWS



MAY 4, 1977

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LETTER OF TRANSMITTAL

MAY 4, 1977.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of members of the Joint Economic Committee and other Members of Congress is a report of the Joint Economic Committee entitled "Issues at the Summit."

The report is based on mid-April hearings involving an outstanding panel of witnesses including representatives from Japan, Germany, Great Britain, the United Nations Conference on Trade and Development, along with American spokesmen for business and labor. It is intended to provide guidance to the President in respect to issues that he will be dealing with in the forthcoming summit meetings with foreign heads of State.

Sincerely,

RICHARD BOLLING,
Chairman, Joint Economic Committee.

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ISSUES AT THE SUMMIT*

On May 7, 1977, President Carter will meet with the heads of state of six other leading industrial countries and the President of the Commission of the European Communities to discuss economic issues that confront all of these nations. While no representative of the oil producing or the non-oil-producing developing countries will be present at the meeting, the actions and requests of these nations have placed several issues on the agenda of the summit and will continue to have a major impact on the industrial economies throughout the foreseeable future. Moreover, meetings with both oil exporters and developing countries will occur shortly after the London summit conference.

On the basis of hearings conducted on April 20 through April 22, 1977, the Joint Economic Committee offers the President before his departure its views on some of the issues that he will be discussing with foreign leaders. In an attempt to include all relevant perspectives in our hearings, we invited not just Americans to testify but several prominent foreigners as well. These individuals from other countries included one of the five members of the Council of Economic Experts advising the German Government, a respected Japanese economist, an advocate of the proposals advanced by the United Nations Conference on

* Senator Roth states, "Due to the press of Senate business, I have not been able to give this report the close attention it deserves, and thus I am not in a position either to endorse or to dissent from the report's findings and conclusions."

Trade and Development (UNCTAD), and an official of the Commonwealth Secretariat. The schedule of our hearings and a complete list of witnesses is appended to this report.

We offer our recommendations for President Carter's consideration and for possible discussion at the summit conference. They are also intended to provide a basis for congressional reflection on these international economic issues.

The recommendations are not intended to be the definitive statement on any of the issues. These questions are too complex to be answered neatly in a few sentences. We submit our views as sensible policy proposals for the United States or, in some cases, for industrialized nations as a group to consider. The United States would be guilty of arrogance if we were to go to the London summit meeting or any other international conference expecting policy decisions reached here to be accepted in toto by other countries. Witnesses at our hearings stressed the desirability, indeed the necessity, of consultations among the major advanced and developing countries before adopting and announcing major new policy initiatives if we are to find willing cooperation and support.

Growth in the Industrial World

The leading industrial countries should commit themselves to agreed growth rate targets and to the use of the policies necessary for assuring realization of these objectives. They should closely monitor current developments and modify stimulus programs as necessary. 1/

The deep world recession of 1974-75 and the sluggish recovery of the leading industrial countries have left most countries in the Organization for Economic Cooperation and Development (OECD) with historically high levels of unemployment. Slow growth in these leading economies has exacerbated the payments difficulties of both weaker OECD countries and the developing world. As a result, protectionist sentiment has been on the rise throughout the industrialized world.

Unemployment, payments imbalances, and the dangers of a trade war would all be reduced by a satisfactory rate of expansion in the industrial countries. The key to economic expansion lies with the stronger economies -- those of Japan, Germany, and the United States.

In Japan, the modest economic recovery that began in 1975 continued through part of 1976. Real GNP that had actually fallen in 1975 grew by 5.7 percent in 1976. The Japanese trade and payments position remained strong. In 1976, Japan recorded an \$11.2 billion trade surplus, a \$4.7 billion current account surplus, and continued to add to its reserves.

There were still, however, a number of trouble spots. Consumer prices in Japan increased 9.4 percent, more rapidly than in most other industrial countries. The unemployment rate rose slightly to 2 percent of the labor force. And by the end of 1976, the economy had stalled.

In response to domestic pressures for renewed growth and international pressures to increase the level of Japanese imports, the Fukuda Administration has adopted a three-step stimulus package. In fiscal year 1977

(the Japanese fiscal year runs from April 1 to March 31), the Fukuda Administration plans to increase spending on public works by \$2.4 billion, decrease taxes by \$2.3 billion, and lower the discount rate substantially.

The Fukuda stimulus package is based on the Japanese Government's target of 6.7 percent growth in 1977. Most economists, however, suspect that the growth rate will be lower -- around 6 percent. The Japan Economic Research Council, a private research group, is even less optimistic. In a recent study, the Council has projected a 5.1 percent growth rate for 1977, with private fixed investment, inventory investment, and personal consumption all growing at rates below the Government's projections.

German economic performance in 1976 was the envy of the Western world. Real GNP grew at more than 5 percent and consumer prices increased by only 4.5 percent. The German trade and payments position is very strong. In 1976 Germany achieved a trade surplus of slightly more than \$14 billion despite a 14 percent increase in the value of the German mark relative to other currencies. Unemployment, however, remained a serious problem. Despite the relatively rapid growth of the German economy, the unemployment rate fell by only one-tenth of one percent to 3.7 percent of the labor force (figures adjusted for U.S. concepts). More than 1-1/4 million Germans are still out of work.

In early 1977, the German Government indicated that it would increase spending in public works by \$5 billion. In late March, the German Government added \$1.7 billion to its proposed package and specifically labeled the change as an attempt to respond to

President Carter's request for greater German stimulus.

The German Government foresees a relatively bright year with the economy growing at over 5 percent, consumer prices rising by only 3.5 percent, and exports growing at between 8 and 10 percent. Some forecasts put the German trade surplus in 1977 as high as \$18 billion despite the expectations of further appreciation in the value of the mark. Not all the forecasts are so confident of German growth. For instance, the OECD foresees real growth in Germany hovering around 3.5 percent. If the OECD forecast proves to be correct, there would be ample room for further German fiscal stimulus.

For the United States, 1976 brought rather mixed economic results. GNP did grow by 6.2 percent and the rate of increase in consumer prices fell more than two full percentage points from 7.3 to 4.8 percent. Although unemployment fell to 7.7 percent for all of 1976, it was higher (7.9 percent) at the end of 1976 than it had been in the first quarter (7.6 percent). Economic growth at an annual rate of 9.2 percent in the first quarter of 1976 slowed in the rest of the year to an annual rate of 3.6 percent. In sharp contrast to Germany and Japan, the United States experienced a \$9 billion trade deficit and a \$0.6 billion current account negative balance.

Reflecting concern over the slowed economy and high rates of unemployment, the Carter Administration proposed a two-year, \$30 billion stimulus package that mixed tax reductions with spending for public works and public service employment. Early 1977, however, brought more rapid rates of both

growth and inflation than had been expected. Despite the exceptionally cold weather in January, GNP grew at an annual rate of 5.2 percent in the first quarter. Industrial production rose by 1.4 percent in March, the biggest monthly increase since August 1975. Retail sales did slump by 2.1 percent in January, but grew 2.7 percent in February and an additional 2.4 percent in March. At the same time, wholesale prices rose sharply in February and March.

In response to the good news about growth and the bad news about inflation, the Carter Administration withdrew the bulk of its tax proposals. The result was virtually to halve the size of the stimulus package and concentrate its impact on 1978.

In its Annual Report, the Joint Economic Committee endorsed a real growth rate of 6 percent and agreed that a fiscal stimulus package in 1977 would substantially improve the prospects for economic growth. The Carter Administration had also drafted their original stimulus plan on the basis of achieving 6 percent real growth. Reflecting the withdrawal of the tax rebate proposal and a reduction in pace of Federal spending, the Administration now expects real growth in 1977 of only 4.9 percent. The recently announced energy plan of the Carter Administration may reduce the growth rate even further. We regret the impact that this reduction in the U.S. growth rate target is likely to have on domestic employment and on growth in other countries.

Despite modest recoveries from the recent recession, Japan, Germany, and the United States have made only limited moves toward fiscal stimulus. In part, this action reflects official expectations of relatively

high levels of economic growth in the year ahead. But it also reflects a broad-based apprehension about renewed inflation. Especially in Germany, but also in Japan and the United States, pressures for economic stimulation have been met by objections that additional stimulus would accelerate the rate of price increase. Inflation, it was argued, would increase business fears and further reduce already low levels of private investment in plant and equipment. In other words, additional governmental action would simply be self-defeating.

Fears of inflation, however, are probably exaggerated. High levels of unused capacity and unemployment suggest that there is little danger of additional inflation resulting from fiscal stimulus. Particularly in the case of the United States, the sudden jump in the Wholesale Price Index is mostly made up of increases in energy costs and a rise in agricultural prices caused by bad weather.

The danger for the world economy is that the three stronger industrial countries will all fall short of their targeted growth rates. If that should happen, not only will their own economies stagnate, but the payments position of the developing world and weaker industrial countries will become more serious.

1/ Senator Humphrey states: "I believe it is essential for the leading industrial nations to establish growth targets that will be sufficient to reduce the unacceptably high rates of unemployment which plague our economies. The restoration of full employment with relative price stability must be the first priority for our coordinated economic policies."

Structural Unemployment

All of the industrial countries are suffering from high levels of structural unemployment. As a first step, the problem of youth unemployment should be explored at an OECD-wide conference to be held in the fall of 1977.

As the industrial structures of the developed countries have become more similar, so have the economic problems -- persistent inflation, falling levels of investment, and high overall rates of unemployment. Throughout the industrial world there are large pockets of unemployment that are structural in nature, particularly among women, minorities, and young people. This problem does not respond readily to fiscal stimulus or eased monetary policy. There is one unemployment problem common to all the developed countries the severity of which demands immediate attention -- jobs for youth. Senator Humphrey and 18 other United States Senators have joined in sending a letter to President Carter calling for an OECD-wide conference on youth unemployment. Such an OECD conference could provide fresh impetus to reduce structural unemployment.

Trade Policy

The December 31, 1977, target date for completion of the current General Agreement on Tariffs and Trade (GATT) negotiations should be extended. Congress and the Executive should cooperate in avoiding the erection of trade barriers and in assuring most-favored-nation access to U.S. markets. The OECD pledge against resorting to trade restrictions should be renewed.

The Trade Act passed in December 1974 authorized the President to enter into a new round of trade negotiations with the objective of lowering tariff and nontariff barriers to trade in agricultural and industrial products. The first tasks for U.S. negotiators, once authorized to participate in what has come to be termed the Tokyo Round, were to agree with the representatives of other countries on how the multitude of individual issues was to be segregated for discussion purposes and on the priority assigned to each group of questions. Much technical preparation has been completed, including exchanges of tariff schedules, discussion of the merits and deficiencies of different proposed rules for reducing tariffs, and the elements of new codes of conduct regarding nontariff trade barriers. As the 1976 elections in the United States, Japan, and Germany approached, both American and foreign negotiators refrained from engaging in substantive negotiations on policy because neither could be confident that any agreement that was reached would be accepted by new political leaders.

During the Rambouillet summit meeting in November 1975, the objective of concluding the Tokyo Round of trade negotiations by the end of 1977 was accepted by the participating countries. This objective was reaffirmed at the Puerto Rico summit in June 1976. Given the limited progress, largely of a technical nature, that has been achieved to date and the need for the Carter Administration to formulate a comprehensive trade policy before the negotiators can begin to grapple with substantive issues, extending the deadline is appropriate.

The choice is one of concluding the negotiations by the end of this year and accepting a limited set of gains or of extending the negotiations within the January 3, 1980, deadline specified in the Trade Act of 1974 and attempting to achieve broader agreement as anticipated by the Act and the 1973 Tokyo Declaration. Significant progress in reducing tariff and nontariff trade barriers and in liberalizing agricultural trade, a chief U.S. interest, requires that the discussions continue beyond the end of 1977. Therefore, the previous target date should be set aside. In its place we should seek to establish a series of interim deadlines keyed to accomplishing each major step in the negotiations.

A number of U.S. domestic industries have appealed for relief from import competition, among them the shoe and color television industries. In both of these cases the International Trade Commission found that imports were in fact a source of injury. In the shoe case the Commission recommended imposition of a tariff-quota, and in the TV case a substantially increased tariff. President Carter rejected the Commission's

recommendation regarding shoes and asked the Special Representative for Trade Negotiations to conclude orderly marketing agreements with major producing countries that would reduce the volume of imports. Perhaps a similar solution will be sought regarding color televisions, especially since the Japanese Government has indicated its willingness to enter into such an agreement.

The President's decision on shoes has avoided the immediate imposition of a higher tariff on imports. But his preference for orderly marketing agreements has its disadvantages. Such agreements deprive producing countries of their right under the General Agreement on Tariffs and Trade (GATT) to demand an offsetting reduction in U.S. duties on other imports or to retaliate by imposing higher tariffs on American exports. From this country's point of view, therefore, orderly marketing agreements are apparently less costly, since we need not compensate foreign countries to account for the jobs and income lost through reduced exports to the United States.

Slow economic growth and high levels of overall unemployment have made it more difficult for workers and individual firms to adjust to rising levels of imports of shoes and television sets. A voluntary agreement may make it easier for the American economy to adapt now. But there are serious domestic costs. The Government collects no tariff revenues, and quantitative limits on imports raise prices to consumers. Purchasers of low-priced textiles, apparel, and shoes -- the type most directly affected by orderly market restraints -- are generally of modest incomes.

An orderly marketing agreement to be effective requires the establishment of a global cartel in the particular product. Although these agreements are not intended to be permanent, once established they are extremely persistent and difficult to dismantle, as the history of orderly marketing agreements in fibers and textiles illustrates. Thus, consumers in importing nations as well as foreign workers who would have produced exports can suffer the consequences of such agreements for years, even decades.

The conclusion of additional orderly marketing agreements would perpetuate the trend toward bilateral solution of trade problems and further undermine the GATT. Since these understandings are generally concluded bilaterally, excluded third countries have little opportunity to represent their interests. Such agreements now exist in fibers and textiles, specialty steels, and a number of products the Japanese export to Europe, including steel, ball bearings, automobiles, certain electronic products, and ships. If this trend continues, the GATT will become so riddled with exceptions that it will no longer be a meaningful agreement.

The New York Customs Court recently decided that by failing to levy certain excise taxes on color television sets exported to the United States, the Japanese Government was subsidizing their sale to this country. The steel industry has brought a similar case regarding the application of the European Communities' value-added tax to steel exports to the United States.

The Court made its decision although it is the general practice of nations not to levy

excise taxes on exports and although non-application is sanctioned by the GATT. Indeed, this is the general practice followed by individual States and by the Federal Government. For example, the Federal excise tax on liquor is not applied to exports. The Common Market also does not apply its internal value-added tax to items that are sold to residents of nonmember countries.

This issue arises because the United States depends largely upon corporate and individual income taxes as the source of Federal revenues, while the European Communities rely upon the value-added tax. It can be resolved in a fashion that does not produce the seriously adverse consequences on trade flows that could conceivably result. The United States could modify its tax system, appellate courts could determine that nonapplication of excise taxes to exports does not constitute a subsidy, or GATT rules could be changed to permit nonapplication of corporate income as well as excise taxes on exported goods.

Trade with developing countries raises a different set of issues. The witnesses testifying, both spokesmen for developing countries and American economists, agreed without exception that one of the most important actions this country can take to help non-oil-producing countries counter the impact of high energy prices and to assist these nations in maintaining reasonable rates of growth is to keep our markets open to imports of their manufactured goods, as well as primary products. At the beginning of 1976 the United States implemented a Generalized System of Preferences (GSP) to assist developing countries in increasing their exports of manufactured goods to this nation. This system confers important benefits, particularly for nations that are

struggling to diversify their exports by selling manufactured goods abroad. For this reason, a system of preferences ought to be maintained. However, across-the-board tariff reductions would in the long run provide greater benefits to these countries. Hence, further expansion of preferences should be carefully examined.

Advanced developing countries and selected industries elsewhere in the Southern Hemisphere are becoming technologically competitive and soon will no longer require the benefit of preferences. These countries and industries should be assured continued access to U.S. markets on at least a most-favored-nation (MFN) basis. Negotiation of additional tariff reductions on an MFN basis can reduce or eliminate the obstacles industrial countries have raised against the processing of raw materials and manufacturing abroad.

Energy Policy

To reduce the pressure for higher world oil prices and to bring U.S. policies into agreement with the objectives of the International Energy Agency, Congress should act promptly to carry out the President's request to cut U.S. energy consumption and to develop domestic energy resources.

High energy costs remain the single most difficult economic problem for the industrialized countries. Quadrupling of oil prices in 1973, coupled with the supply disruptions of the Arab oil embargo, was a major cause of the economic recession in

1974-75. With recovery, demand for energy, and particularly oil imports, has risen again in all industrialized countries, continuing to aggravate the problem of payments imbalances.

In December 1976 the Organization of Petroleum Exporting Countries (OPEC) voted a 10 percent price increase. Saudi Arabia and the United Arab Emirates, however, split with the rest of the cartel by agreeing to hold their price increases to 5 percent and by unilaterally raising their own crude production to meet increased world oil demand. Whether motivated primarily by a desire for intra-OPEC leadership or a wish to bring pressure for peace in the Middle East, these two countries have shown serious consideration for the acute strains of higher oil costs on the world economy and deserve recognition for their responsible action. At the next OPEC meeting in Stockholm this summer, Kuwait and Iran have indicated they too may forgo a further price increase and produce a three-tier price system. The industrialized countries should continue to seek ways to encourage OPEC members to show restraint in future price increases.

The International Energy Agency (IEA) was formed following the 1974 oil price shock to bring the industrialized consuming nations together in a common front to deal with the oil producers. The IEA has succeeded in developing an agreement to share available resources in the event of emergency supply disruptions. It has further sought to promote cooperation in conservation, research, and development, and to consider joint guarantees for energy development schemes. According to the IEA evaluation, the United States has done substantially less well than Japan and most of Europe in its

conservation efforts. Lack of commitment in the United States to a serious energy program has been a major stumbling block to further IEA programs.

On April 20, President Carter announced a national energy program with stringent measures to cut domestic energy consumption over the next five years. While it is yet too soon to comment on the specifics of this program, we heartily endorse the President's strong leadership in announcing this tough program. Sharp reductions in the growth of U.S. demand for oil imports are essential if we are to limit OPEC power to raise oil prices further. At the same time, the United States must move ahead on its program of stockpiling oil to reduce the potential impact of supply disruptions. In considering the President's program, we must give careful attention to minimizing the macroeconomic impact of higher energy costs. Appropriate measures must not be too stringent or phased in too rapidly lest they upset economic recovery at home and damage the world economy.

Exchange Rate Intervention and Adjustment

The International Monetary Fund should promptly develop guidelines regarding market intervention and other government activities that influence exchange rates. Official intervention in exchange markets should be discouraged except to curb disorderly conditions. Moreover, to promote global balance-of-payments adjustment, the industrial countries with strong currencies should not resist pressures in exchange markets tending to raise the value of their currencies.

In contrast to 1976, self-interested intervention in exchange markets to manipulate relative competitive positions is not presently an issue among the major industrial powers. However, given continuing high unemployment rates and increasingly serious trade issues, the principle of refraining from the management of exchange rates to promote exports should be reaffirmed.

The individual member countries of the IMF are now approving amendments to the Fund Articles and a one-third increase in quotas. The Congress endorsed the amendments and quota increase in 1976. The ratification process should be completed by mid-1977.

The revised Article IV says, "The Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to these policies." Recent policy of U.S. monetary authorities has been to avoid intervening in exchange

markets except as necessary from time to time to counter disorderly conditions. A manifestation of this policy is the new Foreign Currency Directive adopted by the Federal Reserve System on December 28, 1976, which states, "System operations in foreign currencies shall generally be directed at countering disorderly market conditions." The Joint Economic Committee has for some years maintained that disorderly conditions in exchange markets should be the sole grounds for intervention by U.S. monetary authorities and has urged U.S. officials to persuade the authorities of other leading industrial countries to adopt a similar policy.

In October 1976, the Subcommittee on International Economics conducted a hearing on guidelines for exchange market intervention. The purpose of this hearing was to investigate whether other industrial countries were intervening in exchange markets to hold down the external value of their currencies in order to expand exports. Of particular concern were Japan and West Germany, since both have strong export positions and both had occasionally intervened in exchange markets to prevent their currencies from appreciating. The extent of exchange market intervention by these two countries and the reasons for such intervention could not be clearly determined. However, it currently appears that if either nation had previously intervened in exchange markets on grounds that were not consistent with the revised Article IV, such practices have now been curtailed, if not eliminated.

Under the revised Articles of Agreement, IMF members shall undertake an obligation to "avoid manipulating" exchange rates or the international monetary system in order to

prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members." Agreement to refrain from these practices is welcome, and the IMF should promptly establish guidelines or a set of operating procedures that will ensure against manipulation of exchange rates through market intervention, domestic monetary policy, tariffs, controls over capital movements, or any other governmental action that can affect exchange rates.

The strong currency countries can and should help deficit nations undertake the adjustments necessary to reduce their external payments drain. As discussed above, industrial nations can keep their markets open to imports of manufactured products from developing countries. The multilateral development banks, as is noted in the discussion below, can help finance the exploitation of new energy sources and encourage the growth of efficient export and import-competing industries. As a third factor in promoting desirable adjustments to reduce payments deficits, as distinct from deflation or protectionism, strong currency countries -- particularly Germany and Japan -- can choose not to resist but instead accept pressures in exchange markets tending to raise the exchange value of their currencies.

The witnesses from Germany and Japan endorsed such action. Both of these countries in 1976 accrued significant trade and current-account surpluses. These surpluses add to the financial strains already imposed upon weaker countries by high energy prices. Japan and Germany should follow the example of the United States in reducing their trade and current-account surpluses and should let the exchange value

of their currencies rise whenever market transactions tend to push them upwards. To the extent that current-account surpluses persist, these countries should lend readily to deficit nations through commercial channels and via participation in the International Monetary Fund and contributions to the multilateral development banks.

Balance-of-Payments Financing

Even with the increase in quotas due to be approved this year, the International Monetary Fund's pool of lendable currencies could soon be depleted. Strong currency countries, including the United States, should contribute additional resources to the Fund that will be available to all members under conditions the IMF establishes.

Total payments deficits of non-oil-developing and weak industrial countries in 1977 will total between \$30 and \$40 billion (Table 1). These deficits come on top of sizable deficits for the last four years. At the same time, commercial bank lending to these countries may stop increasing and could even decline somewhat this year. Therefore an increasing burden is likely to be placed on the IMF to provide balance-of-payments financing and to enable borrowers to avoid deflationary or protectionist reactions to their difficulties. How these continuing payments are to be financed will be a subject of discussion at the London summit conference.

TABLE 1: Current-account balances

(Billions of U.S. dollars)

Group of countries	1973	1974	1975	1976 ¹	1977 ²
OECD.....	2½	-33	-6½	-23	-25
OPEC.....	3½	70½	39½	41	45
Non-oil developing countries..	-2½	-21	-29½	-20	-22
Other countries ³	-4	-9½	-15½	-12	-14
Unexplained discrepancy.....	½	-7	12	14	16

¹Partly estimated.²Projection³Sino-Soviet area, South Africa, Israel, Cyprus, Malta, and Yugoslavia.

Sources: Department of the Treasury, Organization for Economic Cooperation and Development (OECD), and Council of Economic Advisers

The Fund currently has about \$4 billion worth of lendable hard currencies. The quota increase due to be approved in a few months will add approximately \$5 billion to usable IMF resources. Last year the Fund lent about \$8 billion, up from \$5 billion in 1975. Since drawings are likely to increase in 1977, available resources plus loan repayments would permit the IMF to function for only about 18 months. Additional funds totaling about \$3 billion are currently available through the IMF's General Arrangements to Borrow (GAB). But this supplementary facility is available to only the ten major industrial countries, and it too could soon be depleted. More of a cushion is necessary.

During the 94th Congress, the Executive submitted for legislative endorsement a proposed \$25 billion OECD Financial Support Fund. The congressional reaction to this proposal was cool. Although hearings were held in the Senate, the legislation was never reported to the Senate floor. No action was taken in the House of Representatives. This proposal, along with all other pending legislation, died with the conclusion of the 94th Congress.

There is little reason to expect that the OECD Financial Support Fund proposal would fare better in this Congress if resubmitted. Indeed, this proposal was fashioned primarily in reaction to the quadrupling of oil prices, and changes in conditions since that time have made the proposed facility less useful than it might have been earlier. The problem of paying for oil imports is now recognized as an important, but certainly not the only, source of international payments disequilibria. Inflation, business cycle variations, and fluctuations in commodity

prices are also contributing causes. Payments financing should be available to meet all of these difficulties equally.

Lending under the OECD Financial Support Fund was to be conditional on the borrowing nations' efforts to reduce energy consumption and to develop alternative supplies. The conditions attached to loans for financing payments deficits should also include an IMF-type requirement that the borrower adopt appropriate macroeconomic policies. The Fund's staff is experienced and well-qualified to establish the conditions associated with balance-of-payments loans and to enforce these requirements. To give another institution authority to engage in balance-of-payments financing and require it to assemble a staff to perform the same functions as the IMF would entail a wasteful and possibly disruptive duplication of effort. The International Monetary Fund is the appropriate institution to mobilize additional resources for official financing of payments deficits, to establish the conditions under which member countries may utilize these funds, and to disburse them.

How can IMF resources be expanded? Another quota increase would have the advantage of enlarging the potential drawing rights of all Fund members and should be considered. But it would suffer from the disadvantage that many of the currencies paid in as additional quota subscriptions are not readily lendable. Moreover, quota expansions require two or three years to negotiate and implement. The existing GAB is limited in that several of the countries that were potential lenders when the mechanism was established currently have weak external payments positions and are consequently no longer able to lend. A more suitable

supplementary source of resources for the IMF would include strong industrial countries and surplus oil-producing nations as contributors and would provide funds that could be lent to any Fund member for periods of up to two or three years. The conferees at the London summit should endorse the immediate creation of such a super-GAB.

In the last two years, the International Monetary Fund has lent vastly more through its regular resources than previously. OECD countries -- like the United Kingdom, Italy, and Portugal -- have borrowed from it both under the Oil Facility and the regular credit tranches. The number of developing countries turning to the Fund for balance-of-payments assistance, both under regular credit programs and those designed to meet their particular problems, like the Compensatory Financing Facility, is likely to grow in the immediate future.

While commercial banks were able to play an important role in financing deficits in the first years following the oil price increases, there is now growing concern about how much they can prudently further increase their exposure. At the end of 1976, approximately \$80 billion was owed by non-OPEC developing countries to all commercial banks; overall external debt of non-oil-developing countries was estimated at \$180 billion. While several developing countries are currently seeking rescheduling of their credits, a consensus of both public and private sources is that there is no serious prospect of default at this time.

Federal Reserve Board Chairman Burns has suggested that the International Monetary Fund play a greater role in both monitoring commercial bank credits to individual

countries and in assisting these countries to formulate appropriate stabilization policies. While there may be some disadvantages in putting all of the responsibility in one institution, this proposal should be explored thoroughly.

Increased resources for the IMF and suggested expansion of its role as guide for commercial bank lending to developing countries has focused attention on the kind of policies that the IMF pursues to promote economic stabilization. IMF programs have traditionally been short term (a year to 18 months) and have focused on bringing about balance-of-payments adjustment.

It is becoming evident that the adjustment process may be more complex than initially perceived. Sometimes inflation must be curbed, new energy sources must be developed and conservation implemented, recession must be combatted, or realistic exchange rates must be adopted. At other times structural adjustment in a particular sector may be necessary. The Extended Fund Facility was set up for the purpose of financing structural adjustments requiring several years to complete.

With the increasing activity of the Fund, questions have been raised about whether the same standards can, or should, be applied to all potential borrowers. Fund policies may have been too restrictive in some cases and too lenient in others. The Fund should reexamine the criteria behind the policies it employs. Within the confines of available resources, it should seek to pursue policies that are not excessively deflationary. However, the IMF should only finance problems that have foreseeable solutions.

Achieving a More Equitable Economic Order

Three weeks after the London summit, the industrialized and developing countries will meet at another session of the Conference on International Economic Cooperation (CIEC). CIEC has been one of the principal forums for discussing a broad array of issues raised by the developing countries since 1974.

The developing countries have borne a disproportionate burden of current-account deficits resulting from the quadrupling of oil prices and the subsequent slowdown in the industrial economies. Efforts of the strong industrial countries to reflate their economies, to conserve energy, to curb trade surpluses, and to refrain from imposing protectionist trade barriers will benefit the poor countries.

Since OPEC raised prices, discussions ~~between industrial nations and developing~~ countries have become focused on demands of the poor for a new international economic order that would distribute the benefits of economic growth more equitably. While there is general agreement that some greater equity should be achieved, there is little agreement among poor countries on exactly how such a restructuring of the world economy might be achieved. The developed countries, on the other hand, have not been able to propose measures to assist the poor countries in the way that satisfies the latter group. Over the last three years, meetings in numerous forums on these subjects have deteriorated into rhetorical posturing and broken down over specifics.

Despite the seeming repetitiveness and lack of accomplishment in this "North-South"

dialogue, significant changes in economic policy and institutions have been initiated by the industrialized countries to benefit the poor nations. These initiatives are (a) expansion of the IMF Compensatory Financing Facility used to offset shortfalls in export earnings due to commodity price fluctuations; (b) establishment of the IMF Trust Fund to subsidize balance-of-payments loans to the poorest countries with the proceeds of IMF gold sales; (c) a shift to a greater willingness on the part of the United States to negotiate commodity price stabilization agreements; (d) establishment of a compensatory financing facility under the Lome Convention between members of the European Communities and countries in their former colonial areas; and (e) extension of trade preferences for imports of manufactured goods from developing countries by the United States, the European Communities, Japan, and Australia.

On the part of the developing countries, the discussion has produced some more realistic redefinition of the issues. For example, demands for generalized debt relief have largely been dropped. The Group of 24 communique issued at the IMF meetings in Manila in October 1976 reflected the concerns of the more advanced developing countries about maintaining their own access to capital markets and did not demand a general debt moratorium. These countries, nevertheless, do continue to be concerned with the need for debt relief for the poorest nations.

At the summit the industrial countries will be considering what they can and should do for developing nations. Some of the demands raised under the new international economic order -- indexation of raw material prices or a common fund to stabilize the prices of

unspecified commodities, for example -- are clearly not in our interest nor that of a viable international economic system. Other demands of developing countries may make greater economic sense, such as aid transfers, but they require budget commitments within the United States that are difficult, given competing demands. Moreover, the developing countries must themselves adopt appropriate domestic economic policies to be able to take advantage of opportunities when they arise.

In considering remedies to problems the poor countries face, we should seek solutions that mutually benefit both the industrialized and developing nations. Only if we can create a healthy and growing world economy will we be able to accommodate the needs for greater equity of those who have been disadvantaged. Probably the most important single benefit to developing countries would come from the expansion of trade mentioned above.

Commodities

To protect poor countries from sharp fluctuations in export earnings, the United States should continue to consider, on a case-by-case basis, commodity price stabilization agreements, additional needs for compensatory financing, and the adequacy of resources for diversifying exports. In discussing proposals for joint funding of buffer stocks, the United States should not agree to commit funds unrelated to the establishment of specific commodity agreements or to any attempt to raise prices above market trends.

Commodity agreements and the stabilization of the export receipts of developing countries in order to promote uninterrupted growth remains a key issue in the North-South dialogue. The developing countries want to reverse the decline in the terms of trade of raw materials that they have experienced; they see agreements to stabilize earnings in these commodities as critical to achieving this goal. The Integrated Commodity Program proposed by the United Nations Conference on Trade and Development (UNCTAD) would set up a common fund to finance buffer stocks for a core of 18 commodities as they are negotiated.

With a growing recognition of the need for stable export earnings to assure continuing development, the United States has been willing to consider commodity price stabilization agreements on a case-by-case basis. Over the last year, the United States

Government signed and ratified agreements in coffee and tin and indicated its interest in participating in the pending cocoa agreement if specific price levels are renegotiated. We are currently participating in several UNCTAD discussions for other commodity agreements.

Commodity agreements to stabilize prices around an underlying trend could facilitate planning both in the developed and the developing countries and help control inflation. Identifying and agreeing upon this underlying trend of market equilibrium prices, however, is extremely difficult, and there are added problems in policing any commodity arrangement. On the other hand, agreements that fix prices at levels above the long-run market-clearing equilibrium, or that seek to transfer resources by maintaining artificially high prices would not be successful in providing the development benefits sought by poor countries. Such agreements would lead to substitution of alternative products, uneconomic investments, and threats of politically motivated trade restraints.

Because of the difficulties in negotiating individual commodity agreements, the United States has favored stabilizing export earnings rather than prices. The IMF Compensatory Financing Facility was expanded for this end. The United States has also recognized the need to find individual solutions for particular commodities. In some cases, chronic oversupply has led to a declining long-term price trend; then diversification into other crops and manufactured exports is the only way to stabilize export earnings. In other instances, the difficulty of storing

agricultural commodities makes buffer stocks inappropriate.

When and if suitable stabilization agreements that benefit both producers and consumers have been negotiated, adequate funding will probably be forthcoming. Since joint financing of several stocks could be more efficient than independent financing, such possibilities should be explored as soon as enough agreements have been reached. Attempting to appropriate monies for a common fund before concluding the individual agreements would unnecessarily complicate commodity price stabilization negotiations.

Multilateral Assistance

The multilateral development banks should assist the developing countries' adjustment to higher energy costs by financing projects to exploit domestic energy resources and to create efficient export and import-competing industries. The United States should eliminate the arrearages in its pledged contributions to the multilateral development banks and should authorize a \$2.4 billion contribution to the Fifth Replenishment of the International Development Association.

The poor countries need aid at concessional terms. According to the World Bank, per capita annual incomes for the 30 poorest countries still average less than \$160 while those in industrialized countries average over \$5,000. Without transfers of real resources financed by concessional aid from the industrialized nations, few developing

countries can look forward to steady economic growth, since they are not yet able to rely entirely on private capital flows and the benefits of trade.

Higher oil costs severely aggravated the payments deficits of the developing countries. These countries were initially able to forestall necessary adjustments by spending their reserves, borrowing heavily in the private capital markets, and drawing on the emergency programs of the International Monetary Fund. Because many of these countries are nearing their borrowing limits and their deficits are expected to persist, serious attention needs to be given to how these countries can meet higher import costs without relinquishing the goal of continuing economic growth.

The multilateral banks can play an important role in assisting the developing countries' adjustment to higher import costs. In close cooperation with the International Monetary Fund, the development banks should provide financing to foster efficient export- and import-competing industries. They should also seek ways to help poor countries develop competitive domestic energy resources and thereby reduce energy imports.

If the multilateral development banks are to continue helping the poor nations grow and encourage constructive adjustments to payments difficulties, they will need additional capital contributions. The Inter-American Development Bank agreed upon its capital increase last year and the World Bank and the Asian Development Bank are currently seeking capital increases from donor countries. The Fifth Replenishment of the International Development Association (IDA V), agreed to in March 1977, will provide

\$7.6 billion over the next three years in concessional assistance for the very poorest nations. Congress should move quickly to appropriate funds for IDA V and for the agreed capital expansions.

Even with these increased resources, all the development banks must give continuous scrutiny to the quality of the projects that they fund as available resources -- even though seemingly large -- will fall short of the needs of the poorest countries. In addition, attention must be given to ensure that the recipient countries not only meet necessary criteria of creditworthiness, but that they pursue domestic policies generally supportive of the goals of growth, equity, and the improvement of the human condition that underlie our humanitarian support of development efforts.

Support of the International Development Association (IDA) -- the soft loan window of the World Bank -- is particularly important to demonstrate the seriousness of the U.S. commitment to help the Third World. In the past several years, Congress has been slow in providing funds for IDA; in fiscal year 1976 we actually fell behind on our commitment to IDA under the Fourth Replenishment by not appropriating the full amount authorized. Although our portion of the Fifth Replenishment Agreement appears large, as it must be if IDA is to maintain the real value of its ongoing lending, our percentage share continues to decline. While meeting our remaining commitments under the Fourth Replenishment, the United States should strive to commit new funds in step with other donors.

OPEC Participation

The industrial countries should encourage the OPEC countries with large financial reserves to participate more fully in the international lending institutions. OPEC and multilateral development bank aid programs should be coordinated in order to maximize the effective use of available resources.

The OPEC nations have increasingly participated in funding the development banks through contributions and purchases of bonds. This year the oil producers have pledged modest contributions to IDA V. The OPEC nations with financial surpluses however should be encouraged to play an even larger role in the IMF and the multilateral development banks. As mentioned above, these countries should be encouraged to contribute to any expanded super-GAB facility that is approved.

OPEC donors should also be asked to join with the OECD Development Assistance Committee in coordinating aid projects. Whenever suitable, projects should be financed jointly among private investors, the development banks, and OPEC aid institutions.

ADDITIONAL VIEWS OF
SENATOR JACOB K. JAVITS

In general this report is well written and contains constructive suggestions for guiding the Administration at the forthcoming May 1977 Summit Conference. I wish particularly to emphasize the recommendations on structural unemployment, the pledge against resorting to trade restrictions, guidelines regarding market intervention, strengthening the resources of the International Monetary Fund (IMF) and the multilateral development banks, and encouraging greater participation of surplus OPEC countries in the international lending institutions.

The first recommendation of the Report, that "The leading industrial countries should commit themselves to agreed growth rate targets and to the use of policies necessary for assuring the realization of these objectives," reflects an unrealistic view of the situation. In my view, the governments of other industrialized countries such as Germany and Japan are not in a position to -- and are highly unlikely to -- take this rigid a view of committing themselves to specific economic growth rate targets.

At the present time the OECD and the Working Party Three afford excellent forums for Cabinet and Sub-Cabinet level coordination of domestic economic policy actions by the OECD member countries. However, I believe that international interdependence has reached the level where activities of this kind must be carried on at the highest political level.

Several references are made in the report to the need to promote freer trade and to encourage trade as an instrument of economic development, and I agree with the recommendations incorporated in these analyses. But, I believe that the role of private enterprise in international development and in the development of the less developed countries is consistently understated and underemphasized.

The national development plans of less developed countries continually rely on large infusions of private capital. These infusions in turn depend on what has now become an extraordinarily sophisticated and efficient worldwide mechanism for transferring funds, resources and technology vast distances in order to produce and to employ persons all over the world. The LDC critics of multinational corporations and international banking activities are often, as citizens of the world, major beneficiaries of that system.

While I do not believe that competition condones the alleged malefeasance of some international corporations, the fact is that roads, harbors, health care supplies, communications equipment, educational materials, and billions of dollars of other goods and services have found their way to the LDC's through their activities. The thrust of our foreign economic policy, therefore, should be to develop incentives for further liberalizing trade patterns with the LDC's as an integral aspect of our policies towards those countries.

In my view, the issues raised by the call for a New International Economic Order form the key economic -- and therefore, political -- world issues of the coming decade or

decades. Therefore, policy must aim at providing the incentives for private sector growth in such a way as to "internationalize" the mentality of U.S. business -- large and small.

I have some misgivings over one aspect of the report's analysis. While I agree with the fact that the International Monetary Fund is the appropriate institution for mobilizing additional resources for official funding of payments deficits, I do not agree with the implication of the report that the United States should abandon the proposal for the \$25 billion OECD financial support facility. Although, as the report points out, the reception to that proposal in the United States Congress has been cool, the fact is that other OECD countries have enacted or have in place legislation authorizing participation in such a facility.

The need for flexibility in coping with the balance of payments difficulties of both the less developed countries and the weaker industrial countries requires that different financial institutions with different capabilities be put in place, much as business itself has developed new forms of enterprise to deal with the opportunities of world trade. The new, so-called Witteveen Facility proposal recently taken up at the Interim Committee Meeting of the International Monetary Fund, has some practical advantages over the OECD financial support facility, and my views are not meant to recommend a substitute of the latter for the former. However, the OECD facility represents an agreement which has already found considerable acceptance and which would implement the principle that oil payments imbalances between OPEC and the world's industrialized countries can be resolved by

the OECD countries themselves. Therefore, I would hope that the OECD financial support facility will find continued support in the new Administration.

SUPPLEMENTARY VIEWS OF
REPRESENTATIVE CLARENCE J. BROWN
REPRESENTATIVE GARRY BROWN
AND
REPRESENTATIVE JOHN H. ROUSSELOT

While we agree with several of the recommendations in the Committee Report, there are others to which we take exception.

The first is the recommendation that "The leading industrial countries should commit themselves to agreed growth rate targets and to the use of the policies necessary for assuring realization of these objectives."

What the Committee really means by this is something less innocuous. The recommendation should be translated to read, "Japan and Germany should be pressured into deficit spending and faster money creation in order to eliminate their current account surpluses. They should expand their economies more rapidly to encourage imports, in order to help stimulate the economies of the rest of the world by running balance-of-payments deficits."

Should We Pressure Germany and Japan?

We feel that the governments of Germany and Japan know far better than anyone else just how far they can go in expanding their economies before they run into socially and economically unacceptable inflation, with its attendant risk of recession and unemployment. It is not our place to make such a recommendation.

Could Such Pressure Help?

Even assuming that Germany and Japan were willing to try to reduce their current account balances by \$5 billion each, would it help the worldwide economic recovery? No. The size of the impact must be minor.

German trade is roughly \$100 billion of imports or exports a year, out of a gross national product (GNP) which will approach \$500 billion this year. Thus, one-fifth of German spending is for imports. To get an extra \$5 billion increase in imports, in addition to what is expected to occur, German GNP must grow by an extra \$25 billion this year above the amount anticipated. The amount anticipated is already about \$25 billion (5 percent of \$500 billion). If Germany needs to grow by another \$25 billion, that implies a doubling of her real growth rate to 10 percent per year. What fiscal or monetary policy could work that kind of miracle?

Japan, which has let the yen rise sharply for months, and which is not expected to have a current account surplus in 1977, is surely not guilty of misbehavior. Nonetheless, it is being urged to run a deficit of a few billion, say \$5 billion, to help the Third World. Japan's imports are only about one-eighth of a GNP of nearly \$600 billion, so that Japan would have to add an extra \$40 billion to GNP to bring about an extra \$5 billion in imports. Coincidentally, Japan is already growing by about \$40 billion a year, or at a rate of 6 percent. Thus, like Germany, it would have to double its growth rate to provide a \$5 billion deficit for the benefit of other countries.

Suppose that these countries could, in fact, return to fixed exchange rates, double their growth rates, and cause a \$5 billion reduction in Germany's current account surplus, and a \$5 billion current account deficit for Japan. Would this help?

Germany's \$5 billion would be only one-tenth of one percent of the Free World's GNP of \$5 trillion. Adding Japan, we get an increase in demand of two-tenths of one percent. This is truly negligible. Furthermore, most of that will flow to their major trading partners, the United States, Britain, France and Italy. Two of these, Britain and Italy, will simply use part of the money to repay debt while maintaining their austerity programs. This proposal does next to nothing for the Third World.

The Impact on Borrowers in the Third World

As implied above, Germany and Japan can be expected to run an actual payments deficit only under fixed exchange rates. There are a vast number of conceptual problems in saying that a country can run a balance of payments deficit while on floating exchange rates. (While both the German and Japanese floats have been "managed," both the mark and the yen have been allowed to rise significantly over the past year or more.)

Over the past year, both nations' current account surpluses were largely offset by capital account deficits (lending abroad). That is how the balance of payments balances under floating rates.

The implication of the Committee's recommendation that Japan and Germany continue with floating exchange rates and

eliminate or reverse their current account surpluses is that they ought to eliminate or reverse their capital account deficits -- that they should stop lending and start borrowing! Such a policy might aid those Third World nations which would furnish exports to Germany and Japan. However, it would injure those which are deepest in debt and need to restructure or renegotiate their loans. These countries do not want to see an end to German and Japanese lending. Still less do they want to compete with German and Japanese borrowing! This problem was not dealt with during the hearings.

Exchange Rate Adjustments

Later in the report, the Committee recommends that "industrial countries with strong currencies should not resist pressures in exchange markets tending to raise the value of their currencies." We agree. However, the Committee is implying that Japan and Germany have held down the values of the yen and the mark, and that this has contributed to their current account surpluses.

In recent years, both the yen and the mark have risen substantially, with no noticeable impact on the current account balances of either country.

The mark has risen more than 10 percent with respect to the dollar since the beginning of 1976. The yen has risen more than 7 percent. Germany is participating in the EEC currency snake, or joint float. This has somewhat curtailed the free movement of the mark. Nonetheless, substantial increases have been realized.

It is the conclusion of many international trade theorists that devaluations and revaluations have no permanent impact on a country's trade balance.

Old style devaluation theory stated that devaluations could help a country's trade balance, as follows:

"Suppose Britain devalues the pound by 10 percent, and that all British products continue to sell at the same number of pounds as before the devaluation. Then the price of imported wheat in terms of pounds goes up 10 percent, discouraging wheat imports, and British steel looks 10 percent cheaper to foreigners in terms of their own currencies, encouraging British exports of steel. If the effect is strong enough, Britain's trade deficit shrinks. (All this assumes fixed exchange rates, of course, such as under the Bretton Woods system.)"

Modern devaluation theory says:

"That is a nice first step, but will Britain's pound price of wheat and steel stay constant, or of any other product either?" The answer is "no."

British steel was always sold partly in Britain and partly abroad. It could have been sold entirely abroad, but since the British price equaled the world price, some was sold at home. Now, however, foreign steel is selling for 10 percent more, in terms of pounds, overseas. If any steel is to be sold in Britain, the pound price of steel must rise 10 percent, or all of it will be exported.

Similarly, foreign and British producers of wheat would charge the world price, which

enables them to command the same purchasing power over foreign (and domestic) steel (i.e., all other products) as before. That is, wheat would sell for 10 percent more in terms of pounds after devaluation.

This rise in the pound price of all tradeable goods (whether actually traded or not) is followed by an equal rise in the price of British haircuts and other non-tradeable goods. Why? Because nothing has changed the real costs of haircuts versus wheat versus steel, or the public's view of them. If people tried to shift purchases away from the now more expensive steel and wheat into haircuts, the price of haircuts would rise until it was back at the same relative price, compared to steel and wheat, as before.

The conclusion is that devaluation of "x" percent does not permanently alter the trade balance. It simply reflects a simultaneous inflation of "x" percent, or triggers one. On the other hand, a rise in the value of a currency of "x" percent reflects a reduction of "x" percent in the rate of inflation, or helps to bring it about.

The Committee's recommendation is not going to produce the results it assumes.

Commodity Price Agreements

The Committee recommends that "To protect poor countries from sharp fluctuations in export earnings, the United States should continue to consider... commodity price stabilization agreements."

This is a plan to help the Third World indirectly, instead of directly through grants, loans, or freer trade.

The neediest of the Third World countries will need grants to get them through the energy crisis. Those among them and those among the more developed Third World nations with sound plans for permanent growth and adjustment, deserve to be able to get loans to tide them over, either from private banks or from an expanded International Monetary Fund (IMF) or International Bank for Reconstruction and Development.

However, we are now being asked to create a price support program for commodities as part of a long-run solution. As several witnesses noted, this will not bring about efficient development or industrialization of the Third World. It will only create increased dependence on one or two commodities for countries which are already too dependent on this type of production. It would tie up their resources producing commodities for storage instead of valuable goods for trade.

The alternatives of grants, lower tariffs, private investment and multinational lending are to be preferred to commodity price fixing plans.

If commodity stabilization funds are necessary, one should be established for each commodity, as President Carter suggested in his address on Latin America. If one fund were to be established for all commodities, as the Third World has proposed, the various Third World countries would be tied up in knots for years bargaining over how much of the fund would go to support each commodity, and what the support price should be. For

example, Third World nations heavily dependent on coffee production and tin imports would want a large coffee fund with a high support price, and a low tin fund with a low support price, while tin producers who import coffee would want the converse.

Efforts at Self-Help

The implication of some of the witnesses that the developed world has exploited and suppressed the Third World has to be challenged. The United States is more than 90 percent self-sufficient. We import or export less than 10 percent of our GNP. And, what we import, we pay for with exports. We do not seize products, or conduct trade, at gunpoint.

Therefore, we feel it proper to ask the question, "What has the Third World done to help itself?"

Some of these countries have welcomed foreign investment. Some have not.

Some of them have removed exchange rate and foreign exchange controls. Some still stifle their own financial markets.

Some of them have low tax rates and never threaten to nationalize industries. Some scare private help away through threats and political instability.

Some of them allow investment in a normal, honest fashion. Others impose enormous taxes on business in the form of red tape and bribe-taking, which costs multinational companies money and gets them into political trouble at home.

One of the witnesses remarked that "governments feel that it is their business in some measure to choose the pattern of political-economic organization." That is true, provided they are willing to take the consequences. If their political-economic form of organization discourages self-help and private assistance, do they have as much of a claim on foreign sympathy as do those countries which seek private development and encourage self-help?

We should not forget that the Government of the United States is also free to choose its pattern of "political-economic organization." The United States has every right to decide that its own "pattern" is best served by favoring nations which have encouraged their own development and sought after private investment before applying to the U.S. Treasury, over those which have made a bee-line for the money of American taxpayers.

Mrs. Anne Krueger testified that, "No matter what the external environment, or the level of resource transfer, anything that represents a genuine step forward in raising productivity and living standards of the people is going to require at least 90 percent of the inputs from domestic efforts."

We concur, and we are more than willing to help, in as efficient a manner as possible, those nations which share that view.

SUPPLEMENTARY VIEWS OF
SENATOR ORRIN G. HATCH

I support the reservations expressed in the Supplementary views of Rep. Clarence G. Brown, Rep. Garry Grown, and Rep. John H. Rousselot, and I would like to express some additional concerns.

It seems to me that implicitly the Committee Report is recommending world inflation and international price-fixing. Both would, of course, increase the economic misallocation of the world's resources and lessen human welfare.

The scheme to establish price supports for Third World commodities will cause a wasteful misallocation of their scarce resources into the overproduction of the price supported commodities at the expense of their economic development.

The scheme to reflate the domestic economies of the United States, Germany, and Japan will turn these net suppliers of international loans into net borrowers of international loans. To dump the United States, Germany, and Japan into the already crowded international market for loans will only make the financial situation of Third World, large debtor countries more difficult.

Already Italy and Britain have trade deficits and to cover them they have to compete against Third World countries for international loans. If we pressure Germany and Japan out of their trade surpluses and into trade deficits, they also will have to compete against Third World countries for international loans. Every country cannot be a debtor country. The economically

underdeveloped Third World countries need to be debtor countries, because they need to import investment. Therefore, some countries elsewhere must have trade surpluses in order to be able to supply loans.

Germany and Japan cannot simultaneously have trade deficits and supply loans except by transferring their foreign exchange holdings as gifts to the Third World. This would require flexible exchange rates to be abandoned and the German and Japanese central banks to peg the foreign exchange rates of the mark and yen. Otherwise, the exchange rates of the mark and the yen would move, until the payments deficits were eliminated.

If Third World countries want grants, they should ask for them outright instead of concocting inefficient schemes that will reduce their economic development prospects. Our response to these requests must be based on their economic merit and not on any alleged moral compulsion. We have no obligation to lands whose economic opportunities are largely foreclosed by the nature of their political and economic systems and by the absence of extensive and secure private rights to property. We have no obligation to subsidize lands whose only elite is the government class that rules.

On the other hand, those countries that seek to extend economic opportunity to their citizens, rather than restrict it to government, will find that the opportunities created by the energies of private people will generate helpful investment and support from people abroad.

HEARINGS ON
ISSUES AT THE SUMMIT

GROWTH, TRADE AND ENERGY
April 20, 1977

GERASSIMOS ARSENIS

Director, New York Office of UNCTAD

ARMIN GUTOWSKI

Member, German Council of Economic
Experts, Frankfurt am Main, Germany

SABURO OKITA

Special Advisor, International Development
Center of Japan, Tokyo

GEORGE POULIN

Vice-President-elect, International
Association of Machinists and Aerospace
Workers, Washington, D.C.

ROBERT V. ROOSA

Partner, Brown Brothers Harriman and
Company, New York

J. ROBERT SCHAETZEL

Consultant and Writer, Washington, D.C.,
Former U.S. Ambassador to the European
Communities

BALANCE-OF-PAYMENTS
FINANCING AND ADJUSTMENT
April 21, 1977

RICHARD S. ECKAUS

Professor of Economics, Massachusetts
Institute of Technology

PETER B. KENEN

Professor of Economics and International
Finance, Princeton University

WILLIAM J. McDONOUGH

Executive Vice-President, First National
Bank of Chicago

ISSUES IN NORTH-SOUTH DIALOGUE
April 22, 1977

LAWRENCE S. KRAUSE

Senior Fellow, Brookings Institution,
Washington, D.C.

ANNE O. KRUEGER

Professor of Economics, University of
Minnesota, Minneapolis

JOHN P. LEWIS

Professor of Economics and International
Affairs, Woodrow Wilson School, Princeton
University

SRIDATH S. RAMPHAL

Secretary-General, Commonwealth
Secretariat, London